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Supreme Court of the United States
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, and DEAN WITTER REYNOLDS INC.,
Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Petitioners are registered broker-dealers that make markets in over-the-counter securities, trading for their own accounts with their customers. During the class period alleged in this case, the staff of the Securities and Exchange Commission, petitioners' primary regulator, stated that a broker-dealer's "duty of best execution" of customer market orders is satisfied by "executions * * * based on the NASDAQ national best bid or offer [the 'NBBO'] * * * absent customer instructions to the contrary." Execution of small retail orders at the NBBO was also virtually universal industry practice. Nevertheless, the en banc Third Circuit ruled in this case that a broker-dealer's duty of best execution requires it "to maximize the economic benefit to [its customer]" and that a broker-dealer that routinely executes small customer orders at the NBBO may have violated SEC Rule 10b-5 unless it has affirmatively disclosed to its customer that it will not seek better prices. The questions presented by this ruling are:

1. Whether a broker-dealer that makes no false statement, obeys all customer instructions, and routinely executes small retail orders at the NBBO in accordance with SEC guidance and virtually universal industry practice can be found to have acted with "scienter" as defined in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), because it did not seek better prices for the customer.

2. Whether, if a broker-dealer has a fiduciary duty to customers to seek out better-than-NBBO prices, its failure to seek out such prices can be bootstrapped from a breach of fiduciary duty into fraud, notwithstanding *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), simply by alleging that the firm failed to disclose that it would not seek out such prices.

3. Whether, under the "shingle theory," a market maker has an obligation, in determining prices, "to maximize the economic benefit to the [customer]" rather than merely comply with all laws, all SEC regulatory requirements and guidance, and general industry practice.

RULE 29.6 STATEMENT

The following are the parent companies or nonwholly owned subsidiaries of the petitioners:

The parent of petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated is Merrill Lynch & Co., Inc. Merrill Lynch, Pierce, Fenner & Smith Incorporated has no nonwholly owned subsidiaries.

The parent of petitioner PaineWebber Incorporated is PaineWebber Group Inc. PaineWebber Incorporated has no nonwholly owned subsidiaries.

The parent of petitioner Dean Witter Reynolds Inc. is Morgan Stanley Dean Witter & Co. Dean Witter Reynolds Inc. has no nonwholly owned subsidiaries.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
JURISDICTION	2
STATUTE AND RULE INVOLVED	2
STATEMENT	2
The Over-the-Counter Securities Market	3
Retail Customers and the Duty of Best Execution	4
The Duty of Best Execution, the NBBO, and Dealer Profit	5
Respondents' Claims	8
The District Court's Ruling	10
The Third Circuit's Rulings	12
REASONS FOR GRANTING THE PETITION	14
I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS	15
A. The Third Circuit's Decision Is Inconsistent With *Hochfelder*'s Scienter Requirement and With Decisions of Other Courts of Appeals Interpreting That Requirement	15
B. The Third Circuit's Decision Is Inconsistent With Decisions of This Court and Other Courts of Appeals Holding That Rule 10b-5 Prohibits Only Manipulative or Deceptive Conduct	18

TABLE OF CONTENTS—Continued

Page

C. The Third Circuit's Decision Rests on a Construction of the "Shingle Theory" at Odds With Settled Law 21

II. IF LEFT UNREVIEWED, THE DECISION BELOW WILL HAVE EXCEPTIONALLY IMPORTANT CONSEQUENCES FOR SECURITIES LITIGATION AND REGULATION 23

CONCLUSION 28

APPENDICES

A. Opinion of the Court of Appeals, *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (Jan. 30, 1998) (en banc) 1a

B. Opinion of the Court of Appeals, *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (June 19, 1997) 17a

C. Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, 911 F. Supp. 754 (Dec. 15, 1995) 37a

D. Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, No. 94-5343 (DRD) (Sept. 14, 1995) 81a

E. Order of the Court of Appeals, *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (July 30, 1997) 89a

F. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) 91a

G. 17 C.F.R. § 240.10b-5 ..... 92a

TABLE OF AUTHORITIES

CASES

Page

Acme Propane, Inc. v. *Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988) 20
Arleen W. Hughes, 27 S.E.C. 629 (1948) 12, 22
Banca Cremi v. *Alex. Brown & Sons*, 132 F.3d 1017 (4th Cir. 1997) 18, 21, 22
Basic, Inc. v. *Levinson*, 485 U.S. 224 (1988) 27
Bateman Eichler, Hill Richards, Inc. v. *Berner*, 472 U.S. 299 (1985) 27
Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 2, 19, 26, 27
Celotex Corp. v. *Catrett*, 477 U.S. 317 (1986) 27
Central Bank v. *First Interstate Bank*, 511 U.S. 164 (1994) 2, 25, 27
Chasins v. *Smith Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) 16
Chiarella v. *United States*, 445 U.S. 222 (1980) 2, 16, 20
City of New York v. *Clinton*, 985 F. Supp. 168 (D.D.C. 1998) 15
Dirks v. *SEC*, 463 U.S. 646 (1983) 2, 15, 16, 25
Duker & Duker, 6 S.E.C. 386 (1939) 22
E.F. Hutton, 49 S.E.C. 829 (1988) 10
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976) ..... *passim*
Forkin v. *Rooney Pace, Inc.*, 804 F.2d 1047 (8th Cir. 1986) 20-21, 24
International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551 (1979) 26
Lampf, Pleva, Lipkind, Prupis & Petigrow v. *Gilbertson*, 501 U.S. 350 (1991) 27
Marine Bank v. *Weaver*, 455 U.S. 551 (1982) 26, 27
McDonald v. *Alan Bush Brokerage Co.*, 863 F.2d 809 (11th Cir. 1989) 18, 25
Messer v. *E.F. Hutton & Co.*, 847 F.2d 673 (11th Cir. 1987) 17-18
Musick, Peeler & Garrett v. *Employers Insurance*, 508 U.S. 286 (1993) 3, 26-27
Myzel v. *Fields*, 386 F.2d 718 (8th Cir. 1967) 19-20
Pinter v. *Dahl*, 486 U.S. 622 (1988) 25
Platsis v. *E.F. Hutton & Co.*, 946 F.2d 38 (6th Cir. 1991) 16-17

TABLE OF AUTHORITIES—Continued

Page

Pross v. *Baird, Patrick & Co.*, 585 F. Supp. 1456 (S.D.N.Y. 1984) 21
Santa Fe Industries v. *Green*, 430 U.S. 462 (1977) ..*passim*
Schreiber v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) 19
Seibert v. *Sperry Rand Corp.*, 586 F.2d 949 (2d Cir. 1978) 19
Shemtob v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971) 21
Shivangi v. *Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987) 17
United States v. *NASD*, 422 U.S. 694 (1975) 26
Utah State University of Agriculture & Applied Sciences v. *Bear, Stearns & Co.*, 549 F.2d 164 (10th Cir. 1977) 25
Virginia Bankshares v. *Sandberg*, 501 U.S. 1083 (1991) 2
Wassel v. *A.G. Edwards & Sons*, 425 F. Supp. 1205 (D. Md. 1977) 21
Whirlpool Financial Corp. v. *GN Holdings*, 67 F.3d 605 (7th Cir. 1995) 20
Zerman v. *Jacobs*, 510 F. Supp. 132 (S.D.N.Y.), aff'd mem., 672 F.2d 901 (2d Cir. 1981) 21

STATUTES, REGULATIONS, AND RULE

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) ..... *passim*
Securities Exchange Act of 1934 § 11A, 15 U.S.C. § 78k-1 4
Securities Exchange Act of 1934 § 19(b), 15 U.S.C. § 78s(b) 4
Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa 26
28 U.S.C. § 1254(1) 2
28 U.S.C. § 2101(c) 2
17 C.F.R. § 240.10b-5 ..... *passim*
17 C.F.R. § 240.11Ac1-1(b)(1)(ii) 4
SUP. CT. R. 13 2

TABLE OF AUTHORITIES—Continued

OTHER REGULATORY MATERIALS — Page

American Stock Exchange, Inc., Exchange Act Release No. 16518, 45 Fed. Reg. 6521 (Jan. 22, 1980) 9

Small Order Execution System, Exchange Act Release No. 34-33377, 58 Fed. Reg. 69,419 (Dec. 23, 1993) 7

Order Execution Obligations, Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792 (Sept. 29, 1995) 6, 9

Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996) 9

Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments*, 1994 SEC Lexis 136 (Jan. 1994) 5-6, 8

Instinet Corp., SEC No-Action Letter, 1992 WL 672345 (Jan. 15, 1992) 8-9

Instinet Corp., SEC No-Action Letter, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,997, 1986 WL 67657 (Sept. 8, 1986) 9

NASD Manual (CCH) (July 1997) 5, 11

Special NASD Notice to Members 95-43 (June 5, 1995) 10

TREATISES AND LAW REVIEW ARTICLE

4 Alan R. Bromberg & Lewis D. Lowenfels, *Securities Fraud and Commodities Fraud* (1997) 22, 25

Sheldon Jaffe, *Broker-Dealers and Securities Markets* (1978) 22

Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 Wash. & Lee L. Rev. 1271 (1995) 22, 23

Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* (1995) 25

Nicholas Wolfson, Richard M. Phillips, & Thomas A. Russo, *Regulation of Brokers, Dealers & Securities Markets* (1977) 22-23

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Merrill Lynch, Pierce, Fenner & Smith Incorporated, PaineWebber Incorporated, and Dean Witter Reynolds Inc. respectfully petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The en banc opinion of the Third Circuit is reported at 135 F.3d 266 and reprinted at Pet. App. 1a to 16a. The vacated panel opinion is reprinted at Pet. App. 17a to 36a. The opinion of the district court is reported at 911 F. Supp. 754 and reprinted at Pet. App. 37a to 79a. An earlier opinion of the district court is unreported, and is reprinted at Pet. App. 81a to 87a.

JURISDICTION

The judgment of the court of appeals on rehearing en banc was entered on January 30, 1998. This petition is timely filed pursuant to 28 U.S.C. § 2101(c) and Sup. Ct. R. 13. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

Section 10(b) and SEC Rule 10b-5 are set out at Pet. App. 91a and 92a, respectively.

STATEMENT

This Court has repeatedly sought to confine the judicially created cause of action under SEC Rule 10b-5 to cases of actual fraud. *E.g.*, *Chiarella* v. *United States*, 445 U.S. 222, 234-235 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud"); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 177-178 (1994); *Dirks* v. *SEC*, 463 U.S. 646, 666 n.27 (1983); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733 (1975). In particular, the Court has held that Rule 10b-5 applies only if the defendant acted with "scienter"—"intent to deceive, manipulate, or defraud," *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 n.12, 201 (1976)—and that the Rule does not reach ordinary breaches of contract or fiduciary duty or "prohibit any conduct not involving manipulation or deception." *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 473 (1977).

In this putative class action, which challenges millions of small retail securities transactions with an aggregate value of many billions of dollars, the court of appeals has launched Rule 10b-5 on yet another judicially created mission to police conduct that is not fraud. The court—disagreeing with both the district court and the panel—ruled that a securities broker-dealer that makes no false statements, executes all transactions in accordance with

law, regulations, and SEC and National Association of Securities Dealers ("NASD") guidance, and conforms to virtually universal industry practice, may nevertheless violate Rule 10b-5 by failing to tell its customer that it will not take additional steps that a jury might later deem "reasonably available" to "maximize the economic benefit to the client in each transaction." Pet. App. 7a.

This sweeping decision, which conflicts with decisions of other courts of appeals, transforms Rule 10b-5 into a broad mandate for juries to find securities firms liable for federal securities fraud on the ground that they have not acted "reasonably" or have not done everything "feasible" to benefit their customers. The decision invites a proliferation of Rule 10b-5 suits challenging every aspect of broker-dealer conduct. Since such suits will turn on jury determinations of reasonableness and feasibility, they will be difficult to resolve on pretrial motions. This Court should review the Third Circuit's decision in order to restore certainty to an area of the law in which "clarity, consistency, and coherence" are essential. *Musick, Peeler & Garrett* v. *Employers Ins.*, 508 U.S. 286, 295 (1993).

The Over-the-Counter Securities Market

The over-the-counter ("OTC") equity market is a "dealer market" created by securities firms buying and selling stocks for their own accounts. Each dealer that "makes a market" in a particular stock stands continuously ready to buy at the firm's "bid" price or sell at its "offer" price. "By making known the price[s] at which they are willing to transact [purchases and sales] in a particular stock * * * market makers create a competitive structure in which fair prices are arrived at quickly and efficiently." Pet. App. 43a.[1]

[1] A dealer market like the NASDAQ market contrasts with an auction market, such as the New York Stock Exchange. At the NYSE, brokers carrying buy or sell orders for a security physically meet on the exchange floor at the post of a "specialist" who conducts a continuous auction.

These market makers are linked together by an electronic system created at congressional direction, called the NASD Automated Quotation System or "NASDAQ." See Securities Exchange Act of 1934 § 11A, 15 U.S.C. § 78k-1. Every aspect of the market is regulated by NASD rules, which must be approved by the SEC. See Securities Exchange Act § 19(b), 15 U.S.C. § 78s(b). More than 500 market maker firms, communicating by computer, display their "bid" and "offer" quotations in the NASDAQ-listed stocks in which they make markets.

As required by SEC regulations, the NASDAQ computer system receives all market makers' bid and offer quotations and continuously determines the highest bid quoted by any market maker and the lowest offer quoted by any market maker. See 17 C.F.R. § 240.11Ac1-1(b)(1)(ii). This continuously changing pair of quotations "has come to be known as the National Best Bid and Offer ('NBBO')." Pet. App. 44a.

Retail Customers and the Duty of Best Execution

When a retail customer calls a broker to place a buy or sell order, two different things can happen. If the firm makes a market in the stock, it may fill the order by selling from, or buying for, its own inventory. If the firm does not itself make a market, it will act as the customer's agent, communicating the order to a market making firm for execution.[2]

The customer's broker, whether it fills the order itself as principal or acts as the customer's agent, is subject to a fiduciary duty of "best execution." The district court stated that this duty has no single authoritative source and that "[n]o one is sure quite what best execution means in all circumstances." Pet. App. 72a. It said the duty "eludes definition." Pet. App. 68a.

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[2] Merrill Lynch and Dean Witter acted as market makers for named plaintiffs Zakheim and Kravitz respectively. PaineWebber acted only as agent for named plaintiff Binder. Pet. App. 56a.

Two important features of best execution are, however, clear. First, although *price* is an important element, it is not the only element, because a customer is also interested in speed and transaction costs. Accordingly, the SEC has stated that the broker should also take into account "order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Supplemental Brief of the Securities and Exchange Commission, Amicus Curiae (Nov. 21, 1997) at 5; see also Pet. App. 7a n.2. Second, in a dealer market, where a dealer is trading for its own account, sometimes with its customers, best execution must necessarily be defined by law, regulation, and industry custom. The dealer cannot have an unbounded obligation to maximize the customer's profit, because no firm would become a dealer—in securities or any other product—if it had no right to profit in transactions with its customers.

The Duty of Best Execution, the NBBO, and Dealer Profit

The NASD's Conduct Rules state that the dealer's fiduciary duty is discharged by

> us[ing] reasonable diligence to ascertain the best inter-dealer market for the subject security and buy-[ing] or sell[ing] in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

NASD Manual (CCH), Rule 2320 (July 1997). At the time relevant to this case, the SEC staff, the NASD, and the industry believed that "the best inter-dealer market" was the NASDAQ, and that a broker-dealer discharged its fiduciary duty of best execution of small retail market orders by swiftly and routinely (i.e., electronically) buying or selling (or communicating the order to a market maker that would buy or sell) at the NBBO:

The SEC staff. In *Market 2000*, the most comprehensive SEC study of U.S. equity markets since the 1970s, the SEC staff concluded that "it is reasonable to accept

quote-based executions of market orders based on the NASDAQ best bid or offer [i.e., the NBBO] as consistent with best execution, absent customer instructions to the contrary." Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments* ("*Market 2000*") at V-5, 1994 SEC LEXIS 136, at *15 (Jan. 1994). In this case, the SEC staff told the court of appeals in an amicus brief that it

> is not aware, and was not aware during the class period, of any alternative systems offering better prices that were reasonably available (such as by electronic linkages) during the class period for execution of small orders handled by broker-dealers in an automated order routing environment.

Supplemental Brief of the Securities and Exchange Commission, Amicus Curiae (Nov. 21, 1997) at 6-7. After the class period, the SEC reaffirmed that NBBO executions have "long been viewed as satisfying best execution obligations." Order Execution Obligations, Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792 (Sept. 29, 1995).

The NASD. The NASD's General Counsel told the district court in this case that

> [t]he NASD has viewed [execution at the NBBO] as consistent with the duty of "best execution" that broker-dealers assume when they accept customer orders. * * * The NASD has not in the past adopted any rules that required market makers to "cross" market orders with in-house limit orders rather than execute those orders at the NBBO. The NASD also has not required market makers to seek execution of market orders at prices reflected in the Instinet or Selectnet system.

Pet. App. 50a (bracketed material inserted by the court). Indeed, the NASD designed, and the SEC approved, a small order execution system, or "SOES," in which it required market makers to participate, which automatically

executed small orders at the NBBO without human intervention or searches for alternative sources of liquidity.[3]

The industry. Execution of small orders at the NBBO was virtually universal industry practice. Former SEC Chairman David S. Ruder told the district court that:

> [i]t has long been the understanding in the securities industry that investors receive best execution when their small OTC orders are executed at the NBBO. It is the general custom and practice of firms in the industry to execute such orders at the NBBO.

Pet. App. 50a-51a. Accordingly, the district court found and the court of appeals acknowledged that,

> [i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret.

Pet. App. 74a; see also Pet. App. 15a.

Routine execution of market orders at the NBBO enables dealers who make markets to profit on the "spread" between the NBBO best bid and best offer. Pet. App. 43a, 3a. To take a simple example, suppose that at a given moment the NBBO on XYZ shares is 12 bid, 12¼ offered. A market maker that receives a customer order to sell 100 XYZ shares "at the market" may fill the order by buying the shares from the customer at the NBBO bid of 12. If, moments later, the firm receives a customer order to buy 100 XYZ shares "at the market," the firm may (unless the NBBO "offer" has changed in the interim) fill that order by selling 100 shares at 12¼. The ¼ profit represents a return for the market-maker's commitment of capital, and is a fundamental feature of the over-the-counter dealer market. Pet. App. 43a.[4]

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[3] For a description of SOES, see Small Order Execution System, Exchange Act Release No. 34-33377, 58 Fed. Reg. 69,419, 69,420 (Dec. 23, 1993).

[4] The SEC's Division of Market Regulation has observed that the duty of best execution differs, depending on whether the security

Respondents' Claims

Respondents are retail customers who bought or sold NASDAQ-listed stocks between November 4, 1992, and November 4, 1994 (the "class period"). They brought this case as a class action, alleging that petitioners violated Section 10(b) and Rule 10b-5 in connection with the execution of small orders to buy or sell NASDAQ-listed stocks "at the market." They sought an accounting of profits and other compensation received by petitioners on all such transactions (according to the complaint, tens of thousands of transactions daily by each petitioner, see Pet. App. 61a).

Respondents claimed that petitioners had a duty to seek "alternative sources of liquidity" that allegedly might produce better-than-NBBO prices for small retail transactions. Specifically, respondents claimed that petitioners should have executed orders by using "Instinet" or "SelectNet," or by "crossing" respondents' orders with other in-house orders when doing so would have resulted in better prices. Respondents asserted that petitioners' failure to seek better prices by using these alternative methods of execution (or to state affirmatively that they would not do so) violated Rule 10b-5.

Instinet is a private corporation that provides a proprietary system designed to enable subscriber institutions to display anonymous bids and offers to each other. It is not a market maker (that is, it has no obligation to and does not continuously maintain a bid and an offer on any security) but it is a potential source of buy and sell orders. See Pet. App. 45a; Instinet Corp., SEC No-Action Letter,

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is traded in an auction market like the NYSE or a dealer market like NASDAQ, because "with respect to NASDAQ stocks * * * the over-the-counter ('OTC') market is structurally different from the exchange market. It relies on dispersed, competing dealers rather than order interaction." *Market 2000* at V-5, 1994 SEC LEXIS 136, at *15.

1992 WL 672345, at *2 (Jan. 15, 1992); Instinet Corp., SEC No-Action Letter, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,997, at 78,924, 1986 WL 67657, at *13 (Sept. 8, 1986). SelectNet is a communications feature enabling NASDAQ market makers to transmit orders through their NASDAQ terminals rather than by telephone. SelectNet also is not a market-maker: a SelectNet transmittal is a proposal from one dealer to another to engage in a specific transaction in a specific security at a specific price. Pet. App. 44a-45a, 84a. During the class period, Instinet and SelectNet bids and offers were not required to be reflected in the NBBO.[5]

Respondents' other alleged "alternative source of liquidity" was crossed orders. They contended that if a broker-dealer received a market order to buy 100 shares and had another order to sell 100 shares, it had a duty to "cross" them, rather than fill both orders itself and earn a spread. In the class period, no SEC or NASD rule or industry practice required such crossing.[6]

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[5] The duty of best execution has evolved with technological improvements and growth in volume. Before NASDAQ, broker-dealers were expected simply to make three telephone calls to obtain quotations. See Order Execution Obligations, Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792, 52,793 (Sept. 29, 1995). When NASDAQ made all market makers' quotes available on a screen, regulators required dealers to consider all such quotes. See American Stock Exchange, Inc., Exchange Act Release No. 16518, 45 Fed. Reg. 6521 (Jan. 22, 1980).

Nearly two years after the class period, the SEC adopted new order execution rules requiring market makers to incorporate their offers to sell or buy through alternative channels such as Instinet and SelectNet into their quotations on NASDAQ, so that they can be reflected in the NBBO. Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48,290, 48,290-91 (Sept. 12, 1996). Thus, the SEC expanded the content of the NBBO. Notably, it did not require firms to search, on an order-by-order basis, for better prices *outside* the NASDAQ system. See Pet. App. 62a, 77a.

[6] On the contrary, during the class period, the NASD *expressly* permitted the firm to execute a market order at the NBBO, and

Respondents' Rule 10b-5 complaint challenged petitioners' conduct in executing market orders both as principals and as agents. It asserted that, when acting as principals, petitioners improperly executed trades with their customers at the NBBO when better prices were available from Instinet and SelectNet, and improperly failed to cross respondents' orders with other in-house orders. The district court construed the complaint to assert that, when acting as agents, petitioners improperly transmitted orders to market makers who relied exclusively on the NBBO.

Petitioners moved for dismissal on the ground that automatic executions at the NBBO discharged the duty of best execution as stated by the SEC and NASD and as understood throughout the industry. In addition, petitioners contended that respondents could not prove scienter—"a mental state embracing intent to deceive, manipulate, or defraud," *Hochfelder*, 425 U.S. at 193 n.12—because petitioners acted in accordance with regulatory guidance and industry standards. Petitioners also contended that respondents could not establish deception or concealment because respondents made no misrepresentations and the fact that small retail market orders were routinely executed at the NBBO price was publicly known.

The District Court's Ruling

The district court converted petitioners' motion to one for summary judgment and granted the motion. The court found that "[i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret." Pet. App. 74a. The court concluded that petitioners' conduct therefore could not be found deliber-

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earn a spread, even when the firm might instead have crossed the order with an existing limit order. See *E.F. Hutton*, 49 S.E.C. 829 (1988); Special NASD Notice to Members 95-43 at 308 (first question) (June 5, 1995).

ately deceptive: "[Petitioners] cannot have misrepresented material facts by following existing practices and * * * cannot have acted with scienter." Pet. App. 78a.

The district court also gave weight to the practical need to execute small orders at the NBBO:

> [T]he additional inquiries which would have to be made when executing each defendant's tens of thousands of daily relatively small orders might be so time consuming and burdensome that customers would be prejudiced through the inability of broker/dealers to execute customer orders in a timely and inexpensive manner.

Pet. App. 62a. The court added, "It may well be that in any given transaction inquiry of all relevant markets and pending orders might produce a price superior to the NBBO price, but it may not constitute best execution in that transaction because of delay and it may not constitute best execution generally because were the practice followed in all transactions the interests of all customers in an inexpensive and efficient market might be impaired." Pet. App. 69a-70a.[7]

Finally, the district court noted that the SEC had played an active role in defining broker-dealers' obligations and that this task should be left to the agency. The "issues which plaintiffs raise have [since] been and are being specifically addressed by the SEC and NASD" (Pet. App. 76a) including through "proposed regulations [that] are prospective only" and require that the "NBBO should reflect [some additional price quotations] and that some retail limit and market orders should be crossed." Pet. App. at 77a. The court therefore concluded:

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[7] The court's view of the importance of highly efficient electronic executions was correct. From 1985 to 1995, NASDAQ share volume increased 389% to more than 400 million shares traded daily, and dollar volume increased 906% to $2.4 trillion. NASD Manual 157 (CCH) (July 1997). This increase was accomplished without problems of delay in executions or reporting.

> These regulatory developments confirm that defendants cannot have misrepresented material facts by following existing practices and cannot have acted with scienter when only now the regulatory agencies are exploring and adopting regulations designed to meet a continually evolving market. * * * Plaintiffs are effectively asking the court to retroactively second-guess the SEC. While the comprehensive scheme devised by Congress to regulate the securities industry may itself be ripe for reform, the judiciary should not be used as a method to bypass that scheme.

Pet. App. at 78a (footnote omitted).

The Third Circuit's Rulings

On appeal, a panel of the Third Circuit affirmed, holding that respondents could not prove scienter (Pet. App. 25a):

> [W]here defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices.

On rehearing en banc, the Third Circuit reversed and remanded for trial. The court relied on the "shingle theory": the theory that securities professionals, by offering their services, make certain implied representations to clients. See *Arleen W. Hughes*, 27 S.E.C. 629 (1948). The court held that broker-dealers make an "implied representation" that they will "maximize the [customer's] economic benefit" (Pet. App. 6a-7a), and that "a reasonable trier of fact could conclude" that petitioners "intended not to act in a manner consistent with [this implied representation]." Pet. App. 16a, 12a.

The en banc court followed what it described as a "chain of inferences." Pet. App. 13a. It said that "by accepting an order," a firm "impliedly represents that the

order will be executed in a manner consistent with the duty of best execution." Pet. App. 5a. It then interpreted this duty as requiring the firm "to use reasonable efforts to maximize the economic benefit to the client in each transaction." Pet. App. 7a. Maximizing the client's economic benefit, the court said, means that if better prices were "*reasonably available*," because it was "*feasible* for the [petitioners] to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there," petitioners had a duty to execute orders at those better prices. Pet. App. 6a (emphasis added). The court concluded that if a jury could find that it was feasible to execute transactions at prices more favorable than the NBBO, then petitioners' "implied representation * * * that they intended to maximize the plaintiffs' economic gain in the transaction" was false. Pet. App. 12a.

The court noted that "execution of customer orders at the NBBO was a practice widely, if not almost universally followed in the securities industry during the class period," but dismissed this fact because "[e]ven a universal industry practice may still be fraudulent." The court acknowledged, however, that "the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator." Pet. App. 15a. The court did not explain how an implied representation that a firm would discharge its duty of best execution could be rendered fraudulent at the time it was made by the court's later unprecedented interpretation of that duty and a jury's hindsight view of what securities transactions would have been "reasonably available" or "feasible." The court also did not explain how its decision could be reconciled with *Hochfelder*'s scienter requirement or *Santa Fe*'s teaching that breaches of duty or contract, not involving fraud, do not violate Rule 10b-5.

REASONS FOR GRANTING THE PETITION

The Third Circuit's decision conflicts with decisions of this Court and other circuits that have limited Rule 10b-5 to cases involving scienter and actual fraud. The decision eviscerates the scienter requirement, in cases involving broker-dealers, by positing a "representation" that the firm will take every step a jury later determines was "reasonably available," even steps that would have been at odds with SEC and NASD guidance and virtually universal industry practice. The decision also clashes with the principle that Rule 10b-5 catches only fraud, turning the Rule into an open-ended source of federal common law to police the "reasonableness" or "prudence" of broker-dealer practices. Underpinning the Third Circuit's ruling is the mistaken idea that a broker-dealer's "shingle" contains an implicit representation that the firm will do *more* than fully comply with law and trade custom.

The questions presented are of profound importance to the securities industry. This action against three leading broker-dealers itself involves millions of transactions worth billions of dollars. If the decision below stands, many similar cases are certain to follow, since virtually all broker-dealers routinely executed small orders at the NBBO. But the Third Circuit's ruling is not limited to a past period or to matters of price: if that court is right, imaginative plaintiffs and counsel can bring a flood of Rule 10b-5 suits against securities firms, alleging that they have not immediately adapted to "changes in technology and markets" and in this way or otherwise have failed to take all "feasible" measures to "maximize the economic benefit to the client."

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS.

A. The Third Circuit's Decision Is Inconsistent With *Hochfelder*'s Scienter Requirement and With Decisions of Other Courts of Appeals Interpreting That Requirement.

In *Hochfelder*, this Court held that, particularly in view of its statutory provenance, Rule 10b-5 applies only to conduct involving "scienter," which the Court defined as "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. at 193 n.12. "It is not enough" that a broker's conduct allegedly "results in harm to investors; rather, a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors.'" *Dirks*, 463 U.S. at 663 n.23 (quoting *Hochfelder*, 425 U.S. at 199).

The court of appeals did not suggest that petitioners made a false or misleading statement. Pet. App. 6a, 12a. According to the court, (i) petitioners made an "implied" representation that they would offer best execution, (ii) this implied representation included a further implied representation that petitioners would seek out any reasonably "feasible" source of liquidity so as to "maximize [respondents'] economic benefit from the trade" (Pet. App. 6a, 10a), and (iii) a jury could find that this implied representation was false and "that this misrepresentation was intentional or reckless because, at the time it was made, [petitioners] knew that they intended to execute [respondents'] orders at the NBBO price." Pet. App. 16a. Thus, petitioners may be liable for securities fraud if a jury attributes to them a purely constructive "intent" not to conform to a wholly fictitious "representation."

The court of appeals has attempted "to leap a chasm in two bounds." [8] The question, under *Hochfelder*, is whether

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[8] *City of New York* v. *Clinton*, 985 F. Supp. 168, 181 (D.D.C. 1998) (quoting Benjamin Disraeli).

petitioners "intend to deceive, manipulate, or defraud" their customers, and the answer to that question is inescapably "no." At the time petitioners accepted respondents' orders and allegedly made their implied representation that they would seek "best execution," no one had asserted that "best execution" implied a general obligation to "maximize [the customer's] economic benefit" through any "reasonable" or "feasible" means. On the contrary, the SEC, NASD, and industry understanding was that "best execution" of small orders meant swift and routine (indeed, automatic electronic) execution at the NBBO; "profit maximization" in any "feasible" manner was the Third Circuit's own invention. There is simply no basis for charging petitioners with fraud for failing to disclaim, at the time, an intention to take steps that the SEC did not—even two years later (see n.5, *supra*)—require in connection with order executions, and which the Third Circuit has crafted for the first time *now*. Even if respondents could show that the SEC, the NASD, and the rest of the industry were wrong in their assessment of the duty of best execution, and that petitioners were negligent in relying on them, they would not have demonstrated an intent to deceive, manipulate, or defraud.[9]

The decision below is in sharp conflict with decisions of other courts of appeals interpreting *Hochfelder*'s scienter requirement. In *Platsis* v. *E.F. Hutton & Co.*, 946 F.2d 38, 40-41 (6th Cir. 1991), the Sixth Circuit held that a broker's failure to disclose to its customers certain forms of compensation that the broker received (production credits, spreads, and markups) did not violate Rule 10b-5.

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[9] In support of its view that even a universal industry practice may be fraudulent (Pet. App. 15a), the Third Circuit cited *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). But *Chasins* cannot be reconciled with this Court's later decision in *Hochfelder* because scienter was neither required nor found. And it is inconsistent with *Dirks* and *Chiarella*, because, as Judge Friendly pointed out in his dissent for three Judges from the denial of rehearing en banc, "[t]he complaint nowhere asserted that Smith Barney was under a duty to [disclose the information at issue]."

Reversing a securities fraud verdict for plaintiffs, the Sixth Circuit ruled that a mere omission cannot constitute intentional deception in the absence of an established regulatory duty to disclose. The broker's omission was in some sense intentional, but the Sixth Circuit held that there was no scienter, no intent to deceive: "Since very few brokers disclosed these credits at the time these events took place and there was no established regulatory duty to disclose these items, an intent to deceive * * * could not be established merely by the omission of this information in the absence of special circumstances." *Id.* at 41. The Sixth Circuit therefore would have reached a different result than the Third Circuit in this case, where petitioners acted in conformity with regulatory guidance and general industry practice.

The Fifth Circuit would also have decided this case differently, as demonstrated by its ruling in *Shivangi* v. *Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987). There, the court of appeals affirmed the dismissal of a customer's claim that a brokerage firm violated Rule 10b-5 when it failed to disclose that an account executive received a higher commission for a transaction in which the firm acted as a principal than for a transaction in which it acted as an agent. Under *Hochfelder*, this omission involved no scienter because "[a]t the time of the [plaintiff's] purchase, neither the SEC nor any court had determined the compensation information to be material," and there was no indication that "compensation to sales personnel is ordinarily disclosed in the securities industry, a fact that might have indicated to Dean Witter the danger of nondisclosure." *Id.* at 889.

Other courts of appeals would also reject securities fraud claims in a case like this one where a firm followed regulatory guidance and industry practice. The Eleventh Circuit, in *Messer* v. *E.F. Hutton & Co.*, 847 F.2d 673, 678-679 (11th Cir. 1987), held that a firm lacked scienter when it made trades to straddle the plaintiff's futures, which were falling in value, because "straddling an invest-

ment is a common and accepted industry practice to protect an account against extreme losses." See also *Banca Cremi* v. *Alex. Brown & Sons,* 132 F.3d 1017, 1037 n.26 (4th Cir. 1997) (plaintiffs would have a "heavy burden" in proving scienter in the face of "the defendants' adherence to an industry-wide guideline").

The Eleventh Circuit has also rejected the Third Circuit's view that, under *Hochfelder,* a firm acts with scienter if it fails to do something that a fact-finder subsequently determines was "reasonable" or "feasible." See *McDonald* v. *Alan Bush Brokerage Co.,* 863 F.2d 809, 815 (11th Cir. 1989) ("unreasonableness does not meet the standard for scienter"; proving that a broker-dealer's conduct was "not appropriate or reasonable * * * may establish negligence, but it clearly falls far short of demonstrating [intent] or recklessness").

In short, the Third Circuit's ruling is at odds with this Court's scienter decisions and settled scienter law in other Circuits, and plainly warrants review.

B. The Third Circuit's Decision Is Inconsistent With Decisions of This Court and Other Courts of Appeals Holding That Rule 10b-5 Prohibits Only Manipulative or Deceptive Conduct.

Rule 10b-5 is based on a statute, Section 10(b), that bars "manipulative or deceptive device[s] or contrivance[s]." Accordingly, this Court has confined the Rule to fraudulent conduct, rejecting attempts to extend it to other forms of misconduct having some connection to transactions in securities. In *Santa Fe,* the Court rejected a Rule 10b-5 claim by minority stockholders who asserted that they had been improperly frozen out by a short-form merger at a grossly inadequate price. The Court noted that the plaintiffs might have a state-law remedy, 430 U.S. at 478, but ruled they had no Rule 10b-5 claim because "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipu-

lation or deception." *Id.* at 473. The Rule does not cover claims of mismanagement "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." *Id.* at 477. To allow a Rule 10b-5 claim to be based on allegations of breach of fiduciary duty, even when characterized as "fraud in the equitable sense," would "pos[e] a 'danger of vexatious litigation' " and "interfere with" state law "fiduciary standards." *Id.* at 471 & n.11, 478-479 (quoting *Blue Chip Stamps*, 421 U.S. at 740). See *Schreiber* v. *Burlington N., Inc.*, 472 U.S. 1, 12 (1985) (reaffirming the *Santa Fe* principle in the context of the parallel antifraud provision in Section 14(e) of the Williams Act).

The essence of the present case, like *Santa Fe* and *Schreiber*, is a claimed breach of fiduciary duty: respondents claim (and petitioners vigorously deny) that petitioners did not handle respondents' orders in a manner that was reasonably diligent. The Third Circuit would have the jury determine whether better prices were "*reasonably available*" because "it was *feasible* for the defendants to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there." Pet. App. 6a. But the fact that a broker-dealer did not do all that was "reasonable" and "feasible" to maximize its client's return cannot conceivably be a proper basis for Rule 10b-5 liability under *Santa Fe* and *Schreiber*, which require *fraud*.

Nor can there be any serious claim of manipulation or deception here. Routine execution of small market orders at the NBBO was described in official and other literature, see pp. 5-7, *supra*, was virtually universal practice in the securities industry, and was "no secret." Pet. App. at 74a, 15a. The federal securities laws impose " 'no duty to disclose information to one who reasonably should already be aware of it,' " *Seibert* v. *Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978) (quoting *Myzel* v. *Fields*, 386

F.2d 718, 736 (8th Cir. 1967)),[10] and the complaint does not allege that respondents were in fact uninformed about how their orders would be executed, or that they *behaved* in some way different from what they would otherwise have done. See *Santa Fe*, 430 U.S. at 474 n.14 ("respondents do not indicate how they might have acted differently had they had prior notice"). To be sure, respondents here artfully alleged that petitioners' conduct was not only wrongful but deceptive because petitioners failed to announce it in advance. But that kind of "nondisclosure" allegation could be tacked on to virtually any claim of breach of fiduciary duty, bootstrapping it into a claim of fraud and circumventing the principles set forth in *Santa Fe*. See *Chiarella*, 445 U.S. at 232 ("financial unfairness" claims cannot be bootstrapped into "fraud").

Other courts of appeals have routinely rejected, as inconsistent with *Santa Fe*, the theory that alleged breaches of fiduciary duty by a broker-dealer can be transmuted into fraud and brought within Rule 10b-5 by asserting that the dealer "impliedly represented" that it would do its duty. For example, in *Forkin* v. *Rooney Pace, Inc.*, 804 F.2d 1047, 1050 (8th Cir. 1986), plaintiffs claimed that a broker violated Rule 10b-5 when it rescinded a sale of securities to plaintiffs, alleging that in doing so the broker breached an implied "representation of fair dealing." The Eighth Circuit rejected this claim on the ground that "whatever representations may be implicated in the broker-investor relationship," Congress did not intend Section 10(b) to reach "every imaginable breach of fiduciary duty." The court of appeals explained that under a contrary interpretation, "every instance of broker misconduct

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[10] See also, *e.g.*, *Acme Propane, Inc.* v. *Tenexco, Inc.*, 844 F.2d 1317, 1323-1324 (7th Cir. 1988) ("The securities laws require the disclosure of information that is otherwise not in the public domain"); *Whirlpool Fin. Corp.* v. *GN Holdings*, 67 F.3d 605, 609 (7th Cir. 1995).

would give rise to a cause of action under the anti-fraud provisions of the federal securities laws." *Ibid.*

Similarly, in *Banca Cremi*, 132 F.3d at 1035, the Fourth Circuit declined to adopt a theory under which "securities dealers have an inferred duty to disclose certain markups" on sales of securities though the SEC did not require them to do so, and "[d]issatisfied customers who feel that an undisclosed markup is excessive * * * may bring a private cause of action for fraud based on a dealer's failure to meet this inferred duty to disclose." Other circuits have repeatedly rejected fiduciary claims masquerading as securities fraud allegations. See *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (claim based on an alleged oral agreement not to liquidate an account "is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of § 10(b)"); *Zerman* v. *Jacobs*, 510 F. Supp. 132, 134 (S.D.N.Y.), aff'd mem., 672 F.2d 901 (2d Cir. 1981) (same); *Pross* v. *Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (holding that broker trades contrary to express client instructions, while "reprehensible," at most provided "the basis for a claim of breach of fiduciary duty or breach of contract"); *Wassel* v. *A.G. Edwards & Sons*, 425 F. Supp. 1205, 1207 (D. Md. 1977) (unauthorized trades might give rise to a tort or contract claim, but they involved no misrepresentation and could not support a fraud claim).

This Court should grant certiorari to resolve this conflict on an important and recurring issue of federal securities law.

C. The Third Circuit's Decision Rests on a Construction of the "Shingle Theory" at Odds With Settled Law.

The theory that a broker-dealer, by "hanging out its shingle," makes implied representations about how it will act on a customer's behalf is known as the "shingle

theory." The Third Circuit had this theory in mind when it invented an implied representation by broker-dealers that they will take all feasible steps to maximize a client's economic benefit. As the district court recognized, there is no other source for such a representation: "Plaintiffs' allegations here are premised solely on the general nature of the relationship between the parties and make no effort to particularize any misrepresentations." Pet. App. 71a n.11. The court of appeals found support for this new duty in the SEC's 1948 *Arleen W. Hughes* decision, the leading shingle theory case. Pet. App. 7a; see 4 Bromberg & Lowenfels, *Securities Fraud and Commodities Fraud*, at 15:157-15:158 (1997); Jaffe, *Broker-Dealers and Securities Markets* 145-147 (1978). But if the "shingle theory" remains valid at all, the Third Circuit has expanded it beyond recognition.[11]

The established understanding of the shingle theory is that "a broker-dealer, by hanging out his shingle, impliedly represents that he will deal fairly with his customers *in accordance with the standards and practices of the profession*." 4 Bromberg & Lowenfels, *supra*, at 15:158 (emphasis added). See, *e.g.*, *Duker & Duker*, 6 S.E.C. 386, 388 (1939) (implying a representation that the broker-dealer will act "in accordance with the standards of the profession"); *Banca Cremi*, 132 F.3d at 1034 (same); Jaffe, *supra*, at 145 (under the shingle theory, a broker impliedly represents that it will act "in the usual manner and in accordance with trade custom"); Wolfson, Phillips & Russo, *Regulation of Brokers, Dealers, and Securities Markets* § 2.10, at 2-51 (1977) (the shingle

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[11] This Court's decisions "rais[e] questions as to the continuing validity of the 'shingle theory' for broker-dealers." 4 Bromberg & Lowenfels, *supra*, at 5:158. Former SEC Commissioner Roberta Karmel has argued persuasively that after *Santa Fe* and other cases, "the shingle theory is no longer a sound basis for civil liability to private parties under the antifraud provisions." Karmel, *Is the Shingle Theory Dead?*, 52 Wash. & Lee L. Rev. 1271, 1272-1273, 1296 (1995).

theory's implied representation is measured by "the standards of the industry"). As Roberta Karmel has explained, shingle theory standards are based on "industry principles of custom and usage." Karmel, *supra*, at 1275.[12]

The Third Circuit's ruling conflicts with this established understanding and these cases. The court below created an implied representation that a firm would maximize the client's economic benefit by seeking out better prices whenever it was "feasible" to do so. Such a representation is inconsistent with "trade custom," under which the SEC and NASD permitted (indeed, through SOES encouraged) broker-dealers to execute small orders automatically at the NBBO, and nearly every broker-dealer did so. See *supra*, pp. 5-7. In jettisoning the accepted limits of the shingle theory—a theory that even in its traditional form is in tension with this Court's Section 10(b) jurisprudence—the Third Circuit has made a complete end run around *Santa Fe* and *Hochfelder*.

II. IF LEFT UNREVIEWED, THE DECISION BELOW WILL HAVE EXCEPTIONALLY IMPORTANT CONSEQUENCES FOR SECURITIES LITIGATION AND REGULATION.

This case is important in and of itself. Respondents purport to represent a class consisting of "all those persons who placed market orders" with petitioners during a two-year period. They allege that each defendant "*daily* took *tens of thousands* of relatively small orders [covered by the complaint] * * * to buy and sell *tens of millions* of shares of stock." Complaint ¶ 25 (emphasis added). Their discovery requests cover transactions with an estimated value of *$2.7 trillion*. And if the decision below

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[12] Respondents agreed that their transactions would be effected in accordance with the custom and usages of the markets in which those transactions occurred. Confirmation slips typically recited "[t]hat all transactions are subject to the * * * customs [and] usages * * * of the exchange or market * * * where the transactions are executed." Quigley Supp. Decl. Ex. C.

stands, similar claims against every major retail broker-dealer are sure to follow, because the practices challenged were virtually universal.

Even more important, as the Court said in *Santa Fe*, "[t]he reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained." 430 U.S. at 478. Every broker-dealer has general duties in dealing with its customers, including a "duty of best execution" and a "duty of fair dealing." See, *e.g.*, *Rooney Pace*, 804 F.2d at 1050. If broker-dealers are deemed to make an implied "representation" that they will perform those duties, and judges and juries, by later deciding what is "reasonable," "feasible" and "fair," may give content not only to those duties but also to the implied representation, then customers can sue broker-dealers under Rule 10b-5 for virtually any action or inaction they choose to challenge. *Every* step taken, or not taken, in determining price and executing a customer's order could be challenged not only as a breach of the duty of best execution or fair dealing but also as falsifying the defendant's representations and hence violating Rule 10b-5. As the Eighth Circuit recognized in *Rooney Pace*, that would mean that "every instance of broker-dealer misconduct would give rise to a [Rule 10b-5] cause of action"—and every instance of *alleged* misconduct could be pursued with the federal machinery of Rule 10b-5. *Ibid.*[13]

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[13] Different customers could easily allege conflicting implied misrepresentations. In this case, the Third Circuit held that a broker-dealer impliedly "represents" that it will *not* rely on swift, routine execution on NASDAQ at the NBBO when some alternative source of liquidity might be "feasible," as later determined by a jury. But a broker-dealer that spends extra minutes searching for an alternative and *loses* the best price because the market moves away while it is looking could be sued under Rule 10b-5 for "misrepresenting" that it would act swiftly. Both claims could be presented in class actions that require sorting through millions of transactions to determine whether they have any factual merit at all.

For example, the broker-dealer's duty of fair dealing includes duties not to recommend a security without an adequate basis for doing so and not to recommend an investment that is unsuitable for the client. 4 Bromberg & Lowenfels, *supra*, at 15:164-15:167. Under *Santa Fe*, alleged breaches of these duties have not been regarded as a target of the antifraud rules. *E.g.*, Loss & Seligman, *Fundamentals of Securities Regulation* 900 (1995); *McDonald*, 863 F.2d at 815; *Utah State Univ. of Agric. & Applied Sciences* v. *Bear, Stearns & Co.*, 549 F.2d 164, 168-169 (10th Cir. 1977). Now, however, the Third Circuit's decision invites a dissatisfied customer to bring a Rule 10b-5 action alleging that the broker-dealer did not do all that was feasible to research a recommended security (did not use, for instance, the most up to date technology to conduct its research) or did not take all reasonable steps to ensure that a security was suitable for the customer's portfolio.

Opening up all broker-dealer conduct to jury review under Rule 10b-5 will disserve both firms and their customers. This is an area that " 'demands certainty and predictability.' " *Central Bank*, 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). Liability rules " 'offering little predictive value' " must be avoided. *Ibid.* Securities professionals need "guidance as to where the line is" between permissible conduct and securities fraud. *Dirks*, 463 U.S. at 658 n.17. Yet the Third Circuit has invented a rule that, because it depends on a jury's post-hoc view of what was reasonable or feasible, is "inherently imprecise" and "prevents parties from ordering their actions in accord with legal requirements." *Ibid.* See *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1106 (1991) (rejecting expansive fraud theories that would lead to "hazy" issues, "protracted" litigation, and "unreliable" rulings).

Since disputes under the Third Circuit's new theory will turn on judgments about "reasonableness," they will also be difficult to resolve on pretrial motions. As this Court

explained in *Blue Chip Stamps*, "in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value * * * out of any proportion to its prospect of success," if only the plaintiff can survive pre-trial motions. 421 U.S. at 740, 742. The court of appeals' ruling invites the sorts of claims, "brought solely for their potential settlement value," that led this Court to reject expansive interpretations of Rule 10b-5 in *Hochfelder*, 425 U.S. at 210 n.30, and *Blue Chip Stamps*. These practical effects are magnified by the liberal venue provisions of the federal securities laws (15 U.S.C. § 78aa), which make it easy for class action litigants to file suit in the Third Circuit.

The Third Circuit's ruling also ignores the role of expert administrative oversight of public securities markets. See *United States* v. *NASD*, 422 U.S. 694, 729 (1975) (even expressly conferred judicial remedies should not be allowed to undermine SEC supervision); *Marine Bank* v. *Weaver*, 455 U.S. 551, 558-559 (1982); *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 569-570 (1979) (implied remedies under the securities laws should not be expansively construed to conflict with administrative oversight). As the district court recognized, the SEC and NASD have the expertise to respond to changing market and technological conditions, and this is not a necessary or proper role for the courts applying the general fraud prohibition of Rule 10b-5. Pet. App. 75a-79a.

Finally, the interlocutory posture of this case presents no barrier to this Court's review. Immediate review would settle the important questions presented and resolve conflicts between the ruling below and decisions of this Court and of other courts of appeals, "promot[ing] clarity, consistency, and coherence for those who rely upon or are subject to, 10b-5 liability." *Musick, Peeler*, 508 U.S. at

295. In securities cases arising under Rule 10b-5, this Court has frequently granted interlocutory review at the stage when a court of appeals has remanded a case for further proceedings. *E.g., Central Bank*, 511 U.S. 164; *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1991); *Basic, Inc.* v. *Levinson*, 485 U.S. 224 (1988); *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299 (1985); *Marine Bank*, 455 U.S. 551 (1982); *Santa Fe*, 430 U.S. 462; *Hochfelder*, 425 U.S. 185; *Blue Chip Stamps*, 421 U.S. 723. Because such cases pose a special "danger of vexatious litigation" and have an unwarranted settlement value (see *Blue Chip Stamps*, 421 U.S. at 740; p. 26, *supra*) this Court has not hesitated to grant review in this procedural posture.

Respondents have sought discovery with respect to every trade over a two-year period in the second largest stock market in the world. As a member of the Third Circuit panel observed, "You are going to be downstairs trying [this] case if it goes back for years." Tr. of Oral Argument at 9 (Oct. 24, 1996). The district court and panel believed that this case could be resolved based on petitioners' summary judgment motion, so immediate review of the denial of that motion could bring this immensely burdensome action to an efficient end. See *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 327 (1986).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Opinion of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (Jan. 30, 1998) (en banc)

Filed January 30, 1998

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-5045

KENNETH E. NEWTON; MLPF&S CUST. BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

v.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PAINEWEBBER INC.; DEAN WITTER REYNOLDS
(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

On Appeal From the United States District Court
for the District of New Jersey

Argued October 24, 1996

BEFORE: STAPLETON and NYGAARD, *Circuit Judges*, and MAZZONE,* *District Judge*

Reargued En Banc October 29, 1997

BEFORE: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, SCIRICA, NYGAARD, ALITO, ROTH and LEWIS, *Circuit Judges*

(Opinion Filed January 30, 1998)

OPINION OF THE COURT

STAPLETON, *Circuit Judge*:

I.

Plaintiff-Appellants are investors who purchased and sold securities on the NASDAQ market, the major electronic market for "over-the-counter" securities, during the two year period from November 4, 1992 to November 4, 1994 ("the class period"). The defendants are NASDAQ market makers. NASDAQ is a self-regulating market owned by the National Association of Securities Dealers ("NASD"), subject to oversight by the Securities and Exchange Commission ("SEC").

An "over-the-counter" market like NASDAQ differs in important respects from the more familiar auction markets, like the New York and American Stock Exchanges. The NYSE and AMEX markets are distinguished by a physical exchange floor where buy and sell orders actually "meet," with prices set by the interaction of those orders under the supervision of a market "specialist." In a dealer

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* Hon. A. David Mazzone, United States District Judge for the District of Massachusetts, sitting by designation.

market like NASDAQ, the market exists electronically, in the form of a communications system which constantly receives and reports the prices at which geographically dispersed market makers are willing to buy and sell different securities. These market makers compete with one another to buy and sell the same securities using the electronic system; NASDAQ is, then, an electronic inter-dealer quotation system.

In a dealer market, market makers create liquidity by being continuously willing to buy and sell the security in which they are making a market. In this way, an individual who wishes to buy or sell a security does not have to wait until someone is found who wishes to take the opposite side in the desired transaction. To account for the effort and risk required to maintain liquidity, market makers are allowed to set the prices at which they are prepared to buy and sell a particular security; the difference between the listed "ask" and "bid" prices is the "spread" that market makers capture as compensation.

The electronic quotation system ties together the numerous market makers for all over-the-counter securities available on NASDAQ. All NASDAQ market makers are required to input their bid and offer prices to the NASD computer, which collects the information and transmits, for each security, the highest bid price and lowest ask price currently available. These prices are called the "National Best Bid and Offer," or NBBO. The NASD computer, publicly available to all NASDAQ market makers, brokers and dealers, displays and continuously updates the NBBO for each offered security.

Plaintiffs allege that technological advances made it feasible during the class period for the defendant market makers to execute orders at prices quoted on private online services like SelectNet and Instinet and that those prices were frequently more favorable to their investor clients than the NBBO price. According to plaintiffs, the defendants regularly used these services and knew that

prices better than NBBO were often available through them. Even though they knew that their investor clients expected them to secure the best reasonably available price, plaintiffs say, the defendants executed plaintiffs' orders at the NBBO price when they knew that price was inferior and when they, at the same time, were trading at the more favorable price for their own accounts. In this way, they were able to inflate their profit margins at the expense of their investor clients. This practice is alleged to violate section 10 of the Securities Act of 1934, 15 U.S.C. § 78j, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

The plaintiffs also charge defendants with two other violations of section 10 and Rule 10b-5. Market makers who simultaneously hold a market order for both sides of a transaction may obtain more favorable prices than the NBBO by "crossing" these in-house orders. Transactions handled in this way are executed within the spread, giving both the purchaser and seller a better price. Similarly, a customer order can be matched by a market maker with an in-house limit order on the other side of the transaction. Since a limit order specifies a particular price at which to execute a transaction, matching another customer order at that price may beat the currently displayed NBBO quote for that security. Plaintiffs allege that the failure of the defendants to execute orders of their clients in these ways when feasible constitutes a fraudulent practice because, by executing at the NBBO rather than matching customer orders, the defendants capture the full market "spread" as a fee for their services without incurring any actual risk in the transaction.

II.

The defendants filed a motion to dismiss for failure to state a claim upon which relief could be granted. At the direction of the district court, this motion was converted into a motion for summary judgment, which was ulti-

mately granted. *See In re Merrill Lynch Securities Litigation*, 911 F. Supp. 754 (D.N.J. 1995). The district court rested its decision on two principal grounds. First, the court determined that the defendants made no misrepresentation. Though recognizing that the defendants, by accepting plaintiffs' orders, impliedly represented that they intended to execute those orders in conformity with the "duty of best execution," the court considered the scope of this duty sufficiently ill-defined that execution at the NBBO could not, as a matter of law, be found inconsistent with the duty. The court concluded that in the face of uncertainty about the scope of defendants' duty of best execution, holding them liable would be "highly imprudent." 911 F. Supp. at 771. Second, the court held that, even if defendants made a material misrepresentation, they could not, as a matter of law, have acted with the requisite scienter.

To state a claim for securities fraud under § 10 of the Securities Act of 1934 and Rule 10b-5, plaintiffs must demonstrate: (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security; (2) scienter on the part of the defendant; (3) reliance on the misrepresentation; and (4) damage resulting from the misrepresentation. *See Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 296 (3d Cir. 1991). Because plaintiffs have demonstrated that a genuine issue of material fact exists as to the elements of their securities fraud claim, we will reverse the district court.

III.

The parties agree that a broker-dealer owes to the client a duty of best execution. They further agree that a broker-dealer, by accepting an order without price instructions, impliedly represents that the order will be executed in a manner consistent with the duty of best execution and that a broker-dealer who accepts such an order while intending to breach that duty makes a misrepresentation that is material to the purchase or sale. The parties differ, however,

on whether a trier of fact could conclude from this record that the implied representation made by the defendants included a representation that they would not execute at the NBBO price when prices more favorable to the client were available from sources like SelectNet and Instinet.

As we explain hereafter, this difference can be resolved only by determining whether, during the class period or some portion thereof, it was feasible for the defendants to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there. This is a matter concerning which the record reflects a material dispute of fact. If such prices were reasonably available and the defendants, at the time of accepting plaintiffs' orders, intended to execute them solely by reference to the NBBO, they made a material misrepresentation in connection with the purchase or sale of the securities involved. If a finder of fact could infer, in addition, that the defendants' implied representation was knowingly false or made with reckless indifference, it would follow that summary judgment for the defendants was inappropriate.

The duty of best execution, which predates the federal securities laws, has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal.[1] Since it is understood by

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[1] *See, e.g., Hall v. Paine,* 112 N.E. 153, 158 (Mass. 1916) ("broker's obligation to his principal requires him to secure the highest price obtainable"); Restatement of Agency (Second) § 424 (1958) (agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal"). *See also Opper v. Hancock Securities Corp.,* 250 F.Supp. 668, 676 (S.D.N.Y.) ("[T]he duties of a securities broker are, if anything, more stringent than those imposed by general agency law."), *aff'd,* 367 F.2d 157 (2d Cir. 1966). Moreover, as the district court correctly recognized, the best execution duty "does not dissolve when the broker/dealer acts in its capacity as a principal." 911 F.Supp. at 760. *Accord E.F. Hutton & Co.,* Exchange Act Rel. No. 25887, 49 S.E.C. 829, 832 (1988) ("A broker-dealer's determination to execute an order as principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the

all that the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.

The duty of best execution thus requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances. *See, e.g., Sinclair v. SEC*, 444 F.2d 399, 400 (2d Cir. 1971) (fiduciary duty requires broker-dealer "to obtain the best available price" for customers' orders); *Arleen W. Hughes*, 27 S.E.C. 629, 636 (1948) ("A corollary of the fiduciary's duty of loyalty to his principal is his duty to obtain . . . the best price discoverable in the exercise of reasonable diligence."), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). *Accord* Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290, 48322 (Sept. 12, 1996) ("Final Rules"). That is, the duty of best execution requires the defendants to execute the plaintiffs' trades at the best reasonably available price.[2] While ascertaining what prices are rea-

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actual circumstances of any given relationship or transaction.' ") (citation omitted).

[2] Other terms in addition to price are also relevant to best execution. In determining how to execute a client's order, a broker-dealer must take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *See, e.g.*, Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993). When the plaintiffs state that better "prices" were reasonably available from sources other than the NBBO, we understand that to mean that, given an evaluation of price as well as all of the other relevant terms, the trade would be better executed through a source of liquidity other than the NBBO (e.g. SelectNet, Instinet, in-house limit orders or market orders held by the defendants, or limit orders placed by the public in the Small Order Execution System). Similarly, for convenience, we use the phrases "best reasonably available price" and "best terms" interchangeably.

sonably available in any particular situation may require a factual inquiry into all of the surrounding circumstances, the existence of a broker-dealer's duty to execute at the best of those prices that are reasonably available is well-established and is not so vague as to be without ascertainable content in the context of a particular trade or trades.

As the SEC has recognized on a number of occasions, the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of financial markets.[3] For example, before the creation of NASDAQ, a broker in an over-the-counter market satisfied her duty of best execution by contacting at least three market makers prior to executing a client's order. *See* Order Execution Obligations, Exchange Act Release No. 36,310, 60 Fed. Reg. 52792, 52793 (Oct. 10, 1995) ("Proposed Rules"). With the advent of NASDAQ and the NBBO computer system providing instant access to the best bid and offer available nationwide, the standard for satisfying the duty of best execution necessarily heightened. After the class period, the SEC issued rules that altered the definition of the NBBO to include consideration of many of the alternative sources of liquidity that plaintiffs claim should have been consulted during the class period, such as SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48306-16. Prospectively, at least, this heightened the standard still further.

Because the scope of the duty of best execution is constantly evolving and because the "reasonably available" component of the duty is fact dependent, broker-dealers have long been required to conform customer order prac-

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[3] *See, e.g.*, Final Rules, 61 Fed. Reg. at 48322-23 ("The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customers orders, including opportunities to trade at more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become 'reasonably available.' ").

tices with changes in technology and markets. For example, the NASD's Rules of Fair Practice, adopted in 1968, required brokers in the over-the-counter market to "use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under the prevailing market conditions." NASD Manual (CCH), art. III § 1, ¶ 2151.03 (1995) (Interpretation A). Included in the factors used to satisfy the requirement of "reasonable diligence" are both "the number of primary markets checked," and the "location and accessibility to the customer's broker-dealer of primary markets and quotations sources." *Id.*

Almost a year before the end of the class period, the SEC staff issued a report entitled "Market 2000: An Examination of Current Equity Market Developments." This report notes that the SEC has consistently taken the position that the evolving nature of the markets requires a broker-dealer to "periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order." Market 2000 Report, 1994 SEC LEXIS 136, *11-12. As the term "periodically assess" suggests and as the SEC confirms in its amicus briefing before us, this segment of the report was not speaking to the issue of whether, during the class period, the duty of best execution included a requirement that broker-dealers engage in an order-by-order analysis of competing markets. It does, however, expressly recognize a duty on the part of broker-dealers to periodically examine their practices in light of market and technology changes and to modify those practices if necessary to enable their clients to obtain the best reasonably available prices.

The plaintiffs' orders did not specify the price at which they should be executed. It is a reasonable inference that plaintiffs, in placing their orders, sought their own economic advantage and that they would not have placed

them without an understanding that the defendants would execute them in a manner that would maximize plaintiffs' economic benefit from the trade. Given the objective of the agency and the regulatory background we have reviewed, we conclude that a trier of fact could infer that the defendants' acceptance of the orders was reasonably understood as a representation that they would not be executed at the NBBO price when better prices were reasonably available elsewhere. Accordingly, we must examine the record evidence relevant to whether prices quoted on private on-line services like SelectNet and Instinet were reasonably available during the class period and whether those prices were more favorable than the NBBO when plaintiffs' orders were executed.

The evidence pointed to by plaintiffs indicates that (1) SelectNet and Instinet were in existence throughout the class period; (2) the quotations reported by these services reflected buyers and sellers ready to trade at the quoted prices; (3) the defendants themselves actively traded on SelectNet and Instinet during the class period; and (4) other respected members of the brokerage community, since before the class period, have regarded these services as providing reasonably available prices and have executed orders through them when the prices reported were more favorable to the client than the NBBO price. In addition, the plaintiffs have tendered expert testimony confirming the reasonable availability of execution sources other than the NBBO during the class period.

With respect to whether SelectNet and Instinet prices were more favorable at the time their orders were executed, plaintiffs point to an SEC study of prices during the three month period from April through June 1994. The SEC found that "approximately 85% of the bids and offers displayed by market makers in Instinet and 90% of the bids and offers displayed on SelectNet were at better prices than those posted publicly on NASDAQ." Final Rules, 61 Fed. Reg. at 48308. Plaintiffs have also

tendered evidence of a few trades executed for them by defendants at the NBBO where evidence of contemporaneous offers on Instinet and SelectNet indicate that lower prices were available. Plaintiffs have filed a Rule 56(f) affidavit indicating that they need discovery in order to provide similar evidence with respect to the remainder of their trades.[4]

To be sure, the defendants, with record support, insist that consulting other sources besides the NBBO would have added substantial expense and delay to the execution of plaintiffs' orders, more than offsetting any improvements that might have been available in terms of price.[5] This, however, does nothing more than create a material dispute of fact which we are not permitted to resolve in favor of the defendants at this juncture.

We believe the evidence is sufficient to allow a reasonable trier of fact to conclude that, by the time of the class period, both technology and over-the-counter markets had developed to a point where it was feasible to maximize the

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[4] Defendants suggest that the lack of evidence of injury in all plaintiffs' transactions supports an affirmance on the basis of lack of standing. We believe the evidence we have reviewed in text supports plaintiffs' claim to standing. Plaintiffs submitted evidence that would warrant a finding that several trades were made on their behalf when better prices were contemporaneously available from other sources. The SEC study of 1994 prices suggests that, more likely than not, there were other trades in this category. In any event, the plaintiffs have filed a Rule 56(f) affidavit that would preclude a summary judgment for defendants on this issue at this time.

[5] In particular, the defendants rely upon the existence during the class period of the Small Order Execution System ("SOES"). SOES is an electronic routing system that was created in 1984 to allow orders from small investors to be automatically executed at the NBBO. Defendants claim that since the NBBO was the exclusive source for trades executed through SOES, the duty of best execution was presumptively met for these trades. The evidence to which the defendants point supports their position that execution at the NBBO was a common practice in handling orders from small

economic benefit to the client by taking advantage of better prices than the NBBO. Summary judgment for defendants on this element of plaintiffs' claim was therefore not appropriate.

IV.

As we have noted, recovery on a federal securities fraud claim requires a showing of scienter: a deliberate or reckless misrepresentation of a material fact. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985). The alleged misrepresentation here is an implied representation made by the defendants when they agreed to execute the plaintiffs' orders that they intended to maximize the plaintiffs' economic gain in the transaction. Since the defendants knew of the plaintiffs' profit motivation, they must have understood, according to the plaintiffs, that plaintiffs would expect them to obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available. If the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs, plaintiffs insist that the defendants can be found to have made an implied representation that they knew to be false.

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investors. It does not alone, however, require a finding that trades at better prices through SelectNet or Instinet were not reasonably available even for small orders or that a broker-dealer's duty of best execution was automatically discharged by executions through SOES. While size is undoubtedly a relevant factor in determining the scope of the duty of best execution, for summary judgment purposes we find the state of the record with respect to small orders no different than the record with respect to other orders. The affidavit of Richard Y. Roberts, who served as the chairman of the SEC throughout the class period, notes that, to his knowledge, the SEC did not take the position that execution through SOES automatically satisfied the duty of best execution, and indicates that, in his opinion, such a position would be contrary to several SEC releases. At any rate, not all of plaintiffs' orders were executed through SOES.

We believe that a reasonable trier of fact could find this chain of inferences persuasive based on a straight forward economic analysis of the plaintiffs' relationship with the defendants. In addition, however, plaintiffs rely upon evidence showing that respected members of the brokerage community recognized, even prior to the class period, that trades were readily available from sources other than the NBBO and that their clients expected them to take advantage of those sources whenever it would benefit the client. *See, e.g.*, Declaration of Paul M. Lacy [A 718]; Declaration of Junius W. Peake [A 755]; Declaration of Richard Y. Roberts [A 775]. Moreover, the plaintiffs have shown that an SEC study found clear evidence of a two-tiered market during the class period, in which NASDAQ market makers routinely traded at one price with retail clients like the plaintiffs and at a better price for themselves through quotation services like SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48307-08. They have further shown that the possibility that the duty of best execution might require resort to sources other than the NBBO was being actively debated during the class period and that that debate ultimately resulted, shortly after the class period, in a regulation effectively requiring as much. *Id.*

All of this would allow a reasonable trier of fact to find that the defendants' misrepresentation—namely, that they would execute plaintiffs' trades in a manner maximizing plaintiffs' economic gain—was at least reckless, if not intentional. *See Healey v. Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (defining recklessness as an extreme departure from ordinary care).

Defendants have countered with affidavits of other respected members of the brokerage community stating that their practice during the class period was the same as that of the defendants. This evidence could, of course, be regarded by a trier of fact as probative of the defendants' state of mind when they accepted plaintiffs' orders. But

these affidavits do no more than raise a material issue of fact as to whether the defendants knew of the expectation plaintiffs claim to have had; they do not settle the matter.

At trial, the defendants would certainly be entitled to argue to the jury that, because of industry practice, they thought their clients would expect them to execute only at the NBBO or that they never thought about their clients' expectations. Moreover, any evidence, derived from knowledge of industry practice or elsewhere, that the plaintiffs were generally aware of the defendants' exclusive reliance on the NBBO would, of course, be quite probative of whether the plaintiffs had the expectations they claim. But the defendants, in elevating the practice of a segment of the industry to be outcome determinative, lose sight of the fact that the basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal. Based on this mutual understanding and the absence of any express limitations on the brokers' responsibility, a trier of fact could find that the defendants, although intending to execute with sole reference to the NBBO, understood that they were expected to utilize sources other than the NBBO when a better price was readily available.[6]

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[6] The foregoing analysis is generally applicable to plaintiffs' claim that it was reasonably feasible for defendants to "cross" customer orders on opposing sides of a transaction and match customer orders with in-house limit orders. Plaintiffs' record support, including affidavits from respected members of the investment community, raises a disputed issue of material fact as to whether these practices were reasonably feasible during the class period. If the defendants intended to execute plaintiffs' orders at the NBBO despite the reasonable availability of these alternative pricing sources, and if the defendants acted knowingly or with reckless indifference to the falsity of their material representations, then plaintiffs have a securities fraud claim for these practices as well.

V.

In concluding as we do, we are not unmindful of the fact, deemed determinative by the district court, that execution of customer orders at the NBBO was a practice "widely, if not almost universally followed" in the securities industry during the class period. 911 F. Supp. at 772. Under the district court's logic, a Section 10(b) defendant would be entitled to summary judgment even if it were her regular practice to knowingly violate the duty of best execution, so long as she could identify a sufficient number of other broker-dealers engaged in the same wrongful conduct to be able to argue in good faith that the underlying duty was "ambiguous." We cannot accept an analysis that would produce such a result.

Even a universal industry practice may still be fraudulent. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970) (non-disclosure of widespread industry practice may still be non-disclosure of material fact); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 676 (S.D.N.Y.) (industry custom may be found fraudulent, especially on first occasion it is litigated) *aff'd*, 367 F.2d 157 (2d Cir. 1966); *see also Vermilye & Co. v. Adams Express Co.*, 88 U.S. 138, 146 (1874). Indeed, the SEC recently completed an investigation in which it found that certain practices by NASDAQ market makers, not at issue here, were fraudulent even though they were widely followed within the industry. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, 1996 SEC LEXIS 2146 (Aug. 8, 1996).

As defendants emphasize, the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator. On the other hand, there is no statute, rule, regulation, or interpretation, by the SEC or by a court, that authoritatively establishes that, for all trades, the NBBO exhausted the category of "reasonably available prices" during the class period. This absence of

precedent did not, however, absolve the district court of the duty to resolve the plaintiffs' securities fraud claim once it was presented in this suit.

"In the final analysis, ultimate responsibility for construction and enforcement of the securities laws must rest with the court." *Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 94,445, at 95,540, 1974 WL 377 (S.D.N.Y. Mar. 15, 1974). The district court was not deprived of this enforcement authority just because no court or regulator had previously chosen to exercise such authority with respect to the practice challenged here. *See, e.g., Chasins*, 438 F.2d at 1171-72 (finding that defendant's failure to disclose its market maker status was material omission under Section 10(b), despite fact that SEC had never previously held that such disclosure was required).

VI.

On the record before us, we believe a reasonable trier of fact could conclude that the defendants misrepresented that they would execute the plaintiffs' orders so as to maximize the plaintiffs' economic benefit, and that this misrepresentation was intentional or reckless because, at the time it was made, the defendants knew that they intended to execute the plaintiffs' orders at the NBBO price even if better prices were reasonably available. A reasonable trier of fact could thus find scienter with respect to a material misrepresentation, as well as the other elements essential to a Section 10(b) fraud claim. Accordingly, we will reverse the summary judgment entered by the district court and remand for further proceedings.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

Opinion of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (June 19, 1997)

Filed June 19, 1997

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-5045

KENNETH E. NEWTON; MLPF&S CUST. BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

v.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PAINEWEBBER, INC.; DEAN WITTER REYNOLDS
(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

On Appeal from the United States District Court
for the District of New Jersey

Argued October 24, 1996

Before: STAPLETON and NYGAARD, *Circuit Judges*, and MAZZONE,* *Senior District Judge*

(Opinion filed June 19, 1997)

OPINION OF THE COURT

NYGAARD, *Circuit Judge*.

The issue on appeal is whether the over-the-counter customer order execution practices of several large stock brokers constituted securities fraud. The district court concluded that these practices were not fraudulent and granted summary judgment in favor of the defendants. We will affirm.

I.

The facts of this case are set forth thoroughly in the district court's opinion. *In re Merrill Lynch Securities Litig.*, 911 F. Supp. 754 (D.N.J. 1995). Succinctly stated, plaintiffs are investors who purchase and sell so-called "over the counter" securities which are traded on a computerized price quotation system known as NASDAQ. They claim that the peculiarities of this market have given securities dealers an opportunity—upon which they have capitalized—to inflate their profit margins at the expense of customers, resulting in inferior execution prices vis-a-vis other dealers who have access to superior, privately quoted prices. These practices, plaintiffs allege, violated the defendants' duty of best execution, but were never disclosed by the dealers, thus amounting to a securities fraud under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(a) and Rule 10-b5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

* Honorable A. David Mazzone. United States District Court for the District of Massachusetts, sitting by designation.

The NASDAQ, which is now the second-largest securities market in the United States, is different from the New York and American Stock Exchanges, because it is a dealer-created, rather than an auction, market. In an auction market, buy and sell orders actually "meet" on the exchange floor, with prices being set by the continuous interaction of those orders, under the supervision of market "specialists." This type of market has traditionally been used for widely traded securities.

Dealer markets, on the other hand, rely on "market makers" to set prices and maintain the liquidity of securities. This system arose out of literal, over-the-counter trading of stocks that were not as widely traded as those listed on the NYSE or AMEX. In a dealer market, each market maker decides the prices at which it will buy and sell a security; the difference between the listed "ask" and "bid" prices is known as the "spread," from which the market maker is compensated for its efforts and risk.

Under that system, of course, as long as timely, accurate information is available regarding each market maker's prices, orders will naturally gravitate towards the dealer with the most favorable prices, and this will establish a single, albeit two-price, market for each security traded. NASDAQ (which stands for National Association of Securities Dealers Automated Quotation) is the information system that relays market makers' pricing information to buyers and sellers. NASDAQ quotes the National Best Bid and Offer—known in the industry as the "NBBO"—price for every stock on the system.

Because of recently created sources of additional, non-public pricing information, however, the NBBO may no longer always be counted upon to display the "best" price. Systems such as SelectNet and Instinet, which are not available to all investors or even to all dealers, may be quoting a more favorable price than the NBBO at any given moment. Appellants allege that, not only were bet-

ter prices displayed in many instances, but that the defendant dealers knew such prices were available, yet continued to book their orders at the inferior, NBBO price at the same time that they were trading at the more favorable price for their own accounts.

In addition, in many instances dealers are able to obtain more favorable prices by "crossing" the customer's order with the order of another customer. For example, assume that a dealer quotes an "ask" price of $32¼ and an "bid" price of $32 for shares of XYZ Corporation. A customer places an order to purchase 100 shares, but, unbeknownst to him, the dealer has an outstanding limit order from another customer to sell at 32⅛. That dealer could simply cross the two orders and execute the trade at 32⅛, saving the customer $12.50. The dealer would not incur any market risk on such a transaction. Appellants allege that it is a fraud for the defendant dealers to continue to execute trades at the NBBO price, appropriating the full "spread" as a fee for their services.

The district court granted summary judgment to defendants, for two principal reasons. First, it held that defendants made no actionable misrepresentations, because the duty of best execution is ill-defined and there is no widely accepted view that execution of trades at the NBBO price fails to satisfy that duty; thus, it would be improper to find that defendants omitted or concealed material facts. 911 F. Supp. at 771. Second, the court held that, even if defendants omitted information, they could not, as a matter of law, have acted with the requisite scienter. *Id.* at 772.

II.

A.

To make out a securities fraud claim under § 10 of the Securities Act of 1934 and Rule 10b-5, plaintiffs must

show: (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security; (2) scienter on the part of the defendant; (3) reliance on the misrepresentation; and (4) damage resulting from the misrepresentation. *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 296 (3d Cir. 1991). Although the district court held that there was no misrepresentation or omission of a material fact, we will assume, without deciding, that the trading practices here constituted an otherwise actionable misrepresentation, because we conclude that the district court correctly decided that scienter was lacking as a matter of law, and appellants' securities law claims fail on that basis alone.

The element of scienter has been defined as "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 96 S. Ct. 1375, 1381 n.12 (1976). Scienter can also be established by a showing of recklessness, which is defined as "an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading . . . that is either known to the defendant or is so obvious that the actor must have been aware of it." *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (quoting *Sundstrand v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)). The recklessness standard comprehends actions very close to intentional conduct; mere indifference to the consequences of a statement is not sufficient. *Healey*, 616 F.2d at 649.

Appellants assert, nevertheless, that the record before the district court contained sufficient evidence from which a rational factfinder could infer scienter. The district court disagreed, opining that because the duty of best execution is not "established," but ambiguous, the failure to disclose that all orders were being executed at the NBBO price could not, as a matter of law, have involved scienter. We agree.

Appellants attempt to refute the district court's reasoning by arguing that "the absence of a regulation prohibiting a specific practice does not mean such practice cannot be considered fraudulent." Specifically, they rely on our decision in *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3d Cir. 1987), which they assert is "directly on point." We are not persuaded.

It is true that *Ettinger* involved a securities firm that failed to disclose excessive markups, but there the similarity to this case ends. The dealer in *Ettinger* argued that its compliance with Rule 10b-10 insulated it from a material misrepresentation attack under Rule 10b-5, and we held simply that such compliance did not preclude a 10b-5 action. *Id.* at 1036. Moreover, *Ettinger* involved a markup practice that both the SEC and the courts had already condemned—the duty in that instance, unlike here, was clear. *See id.* at 1033. And finally, scienter was not even an issue in *Ettinger*. It had been waived in the district court. *Id.* at 1036 n.7. *Ettinger* is inapposite.

Appellants also cite several cases which allegedly stand for the proposition that violations of § 10(b) can occur when a broker-dealer fails to execute customer orders at the best possible price. Two of those cases, however, involved execution practices that no reasonable dealer could have possibly believed proper. *See Barnett v. United States*, 319 F.2d 340, 345 (8th Cir. 1963) (excessive mark-ups of between 25 and 67% not disclosed; customer order never executed at advertised price, while dealer was trading same security for its own account at superior price); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 673 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966) (dealer claimed to be searching unsuccessfully for buyer to purchase customer's stock, while at the same time trading in that same stock profitably for its own account). Three other cases interpose a third-party dealer in the transaction, thus increasing the customer's expense; this

practice had already been condemned by long-standing judicial and regulatory authority. *See Sinclair v. SEC*, 444 F.2d 399, 400 (2d Cir. 1971); *In re Delaware Management Co.*, 43 SEC 392, 399-400 (1967); *In re Hoit Rose & Co.*, 1969 SEC LEXIS 244 (1969).[1]

As the district court recognized, the most instructive case on the issue of scienter is *Platsis v. E.F. Hutton & Co.*, 946 F.2d 38 (6th Cir. 1991). There, a broker failed to disclose its production credits, spreads or markups, while at the same time it was profiting from customer transactions against its own inventory. The district court found, after trial, that defendants had acted with scienter, but the court of appeals reversed because there was no established regulatory duty to disclose and intent to deceive could not thus be established by omission. Here, as in *Platsis*, the dealers were under no established duty to execute trades at other than the NBBO price or to disclose their execution practices. Indeed, it appears that the industry as a whole used the NBBO to satisfy the duty of best execution. Under the reasoning of *Platsis*, then, which we adopt, there was no scienter. *Accord Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987) (failure to disclose sales compensation did not involve scienter when no court or regulator had ever held that information material and there was no evidence that its disclosure was normal industry practice).[2]

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[1] Indeed, the only authority appellants are able to cite with facts similar to the present case is an unpublished district court opinion in typescript. *Lesko v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. C78-1740 (N.D. Ohio June 22, 1979), in which the court opined, with very little analysis, that a deliberate policy of sending all orders to the AMEX rather than "seeking the best price in the available markets" stated a claim for securities fraud. That court did not discuss scienter, and is thus inapposite, whatever its relative persuasiveness.

[2] The district court and appellees maintain that this circuit already follows a *Platsis*-like rule. In *Christidis v. First Pennsylvania*

On the other hand, in *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), a broker failed to disclose that it was making a market in certain securities it strongly recommended, and then sold, to plaintiff. Although scienter was not directly at issue in *Chasins*, the court did opine that all brokerage firms had followed the same practice and had never thought such disclosure was required. Moreover, the SEC had never prosecuted any firm for this violation. Indeed, as here, the practice at issue in *Chasins* was later addressed by regulation. *Id.* at 1171 n.5.

Nevertheless, we decline to apply *Chasins* to this fact pattern. First, the holding there did not address scienter. *See Architectural League v. Bartos*, 404 F. Supp. 304, 315 (S.D.N.Y. 1975) ("All that . . . *Chasins* holds . . . is that failure to disclose market-maker status was . . . the omission of a material fact. The omission of a material fact, without more, does not violate Rule 10b-5. All other elements, including scienter, must be proven[.]"). Second, in *Chasins*, appellant's contention that *nobody* thought disclosure was required was demonstrably false, having been impeached by appellant's own witness. 438 F.2d at 1171. That is not the case here. Finally, and most importantly, in *Chasins* the dealer was strongly recommending that the customer buy certain securities in which the dealer itself was making the market. The dealer thus had

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Mortgage Trust, 717 F.2d 96 (3d Cir. 1983), plaintiffs sued an accounting firm, alleging that it fraudulently failed to prepare financial statements in accordance with generally accepted accounting principles. Although scienter as such was not an issue, we affirmed the dismissal of the complaint for lack of particularity in pleading fraud under Fed. R. Civ. P. 9(b). *Id.* at 100. We do not read *Christidis* as itself adopting the proposition that failure to disclose cannot involve scienter where there is no clear duty to do so and the practice at issue is common in the industry. It was simply a case involving the pleading standard for allegations of fraud. Nevertheless, we think that *Platsis* is persuasively reasoned and we adopt it here.

an undisclosed conflict of interest of major proportions; to the extent that the customer followed its "advice," the dealer made more money. *See Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 885 (5th Cir. 1973) (distinguishing *Chasins* on this basis); *Batchelor v. Legg & Co.*, 52 F.R.D. 553, 557 (D. Md. 1971) (similar).

We therefore hold that, where defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices.

B.

In this case, although it appears on the surface that appellants have adduced evidence that the nondisclosures at issue here were not common industry practice, closer examination reveals that contention to be unsupported. Appellants first cite the deposition testimony of Paul M. Lacy, a retired securities trader, for the proposition that "other broker-dealers do not execute customer orders with exclusive reference to NBBO." His testimony supports nothing. Mr. Lacy retired *before* the beginning of the class period (November 1992), and therefore cannot offer any competent, firsthand testimony about industry practices as they existed at the times material to this litigation. Of even greater significance, Lacy did not even testify about the practices of other securities dealers in general or even his former firm in particular, but testified only about *his own* practices as a trader within that firm.

Appellants also rely on proposed SEC rules on order execution as confirmation of Lacy's testimony [A 609]. *See* Order Execution Obligations, 60 Fed. Reg. 52,792 (1995) (to be codified at 17 C.F.R. pt. 240) (proposed Oct. 10, 1995). That document recites that traders use "a variety of systems and procedures" to satisfy best exe-

cution. *Id.* at 52,794. If traders use a *variety* of systems, however, that bolsters the district court's conclusion that there was no clear duty to supplement the NBBO price and that failure to disclose the practice of executing all trades at the NBBO price could not have involved scienter.

Appellants likewise refer us to the opinions of a trader and a former SEC commissioner who believe that the duty of best execution requires affirmative efforts to supplement the NBBO with other sources of pricing. *See National Market System: Hearings Before the Subcomm. on Telecommunications & Finance of the Comm. on Energy & Commerce,* 103d Cong., Serial No. 103-67, at 355 (1993) (statement of securities dealer Bernard L. Madoff that he believes it is the obligation of a market maker to achieve price improvement whenever possible and does so in fifty percent of all trades); Declaration of former SEC Commissioner Richard Y. Roberts, [A777] ("[i]t would be inconsistent with the duty of best execution for a broker-dealer to advantage itself by automatically executing customer orders at the NBBO when superior prices are reasonably available"). This evidence, however, is insufficient.

To prevail on summary judgment, one need not show that *every* dealer executes trades at the NBBO price, but merely that enough dealers do so that the duty to supplement the NBBO price is *ambiguous* and scienter is negated. There is more than ample evidence of that. David S. Ruder, a former Chairman of the SEC, member of the NASD board and law professor at Northwestern University, stated by affidavit that trades at the NBBO price satisfied the duty of best execution and that the general custom and practice of firms in the industry was to execute at the NBBO price [A225-27]. T. Grant Callery, General Counsel to NASD, also stated by affidavit that NASD views the NBBO price as satisfying the best execution duty [A 458]. Finally, Hugh Quiqley, a trader at Merrill

Lynch, declared that he had observed the trading practices of every major firm in the industry and observed that the standard practice was to trade at the NBBO [A 497].

Finally, while this case was pending on appeal, the SEC finalized new regulations pertaining to order execution which address directly the practices at issue here. *See generally* Self-Regulatory Organizations; National Association of Securities Dealers; Order Granting Partial Approval and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to Proposed Rule Change Relating to Implementation of the Commission's Order Handling Rules, 62 Fed. Reg. 2415 (Jan. 16, 1997). Under these new rules, which became effective on January 20, 1997, market makers must display a customer's limit order when the price of that order is superior to the current NBBO quote. Moreover, any superior prices quoted on electronic communications networks such as SelectNet and Instinet must be listed as part of the NBBO price. *See* SEC News Release 97-3, *New Trading Rules for NASD and the Exchanges*, 1997 WL 21042 (Jan. 20, 1997). By these regulatory changes, dealers will essentially be required to eliminate the practices that appellants complain of in this case. We believe, as did the district court, that the fact that the Securities and Exchange Commission perceived the need to address these order execution practices through the regulatory process indicates strongly, if not conclusively, that the "duty" to cross orders and to look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period. Regulatory agencies would not spend the time, money and effort in promulgating regulations if the duty it sought to impose were already clear under established law.[3]

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[3] We do not mean to imply, however, that the duty of best execution is in any way unenforceable in a private action under § 10(b) of the 1934 Act. Where the duty is clear, or where a practice is

III.

In sum, the evidence in this record is legally insufficient for a rational jury to infer that defendants failed to disclose their "NBBO-only" execution policy knowing that it was fraudulent not to do so, or that they recklessly ignored massive evidence suggesting that it was. Accordingly, the district court correctly found no scienter and properly entered summary judgment for defendants. We will affirm.

STAPLETON, *Circuit Judge*, dissenting:

During the class period, Section 10(b) and Rule 10(b)-5 (hereafter referred to collectively as "Section 10(b)") imposed upon the defendants a duty not to deliberately mislead their clients. The plaintiffs allege that, when the defendants received the plaintiffs' orders, the defendants knew both (1) that the plaintiffs expected them to execute these orders at a better price than the NBBO if the opportunity to do so presented itself, and (2) that the defendants themselves had no intention of referencing anything other than the NBBO. The issue for decision is whether the plaintiffs have produced sufficient evidence from which a trier of fact could reasonably infer that one or more of the defendants had this state of mind when they accepted the plaintiffs' orders for execution. I conclude that they have and that summary judgment for the defendants is therefore improper.

I.

The class period extends from November 4, 1992 to November 4, 1994. The district court granted summary judgment to the defendants primarily because the SEC, during that period, had not explicitly declared that the

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obviously fraudulent and not pervasive throughout the securities industry, the mere lack of regulations directly addressing the practice at issue will not constitute a bar to such a suit.

duty of best execution included the duty to consult reasonably available sources other than NBBO. Because resolving that issue involved considerations within the scope of the SEC's expertise, the district court believed it would be inappropriate for the courts to recognize a legal duty to consult other sources during the class period. I find the district court's approach unacceptable because it mistakenly equates the SEC's lack of guidance with an absence of any relevant law.

Our court reaches a somewhat different conclusion. It finds that the SEC's post-class period decision effectively eliminating the practices of which the plaintiffs here complain[1] "indicates strongly, if not conclusively, that the 'duty' to . . . look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period." Slip Op. at 11. The court then concludes that there was applicable law during the class period and that it was established by the way in which a segment of the regulated profession behaved during that period. Thus, the defendants are entitled to summary judgment, we are told, because they have shown "that enough dealers [referenced only the NBBO during the class period] so that the duty to supplement the NBBO price [was] ambiguous and scienter is [therefore] negated." *Id.* at 10 (emphasis omitted).

I believe that Congress established the principles of law applicable here when it enacted Section 10(b) and that

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[1] The SEC proposed in 1995, and implemented in 1997, amendments to the "Quote Rule" which now require market makers to include in the NBBO any superior price they are quoting on electronic communications networks like SelectNet or Instinet. *See* Order Execution Obligations, Exchange Act Release No. 36,310, 60 Fed. Reg. 52972 (Oct. 10, 1995) ("Proposed Rules"); Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290 (Sept. 12, 1996) ("Final Rules"). Since the new NBBO incorporates a far wider range of prices, the possibility of executing a trade at an inferior NBBO price when better prices are available on an electronic communications network has been eliminated.

these principles were not ambiguous during the class period. The district court's task was to apply those unambiguous principles to the circumstances of each transaction between a plaintiff and a defendant. Because there are material disputes of fact concerning those circumstances, I would reverse and remand for further proceedings.

II.

The relationship between a client and a broker is that of a principal and an agent. Absent special circumstances, it is a relationship in which it is understood by all that the client-principal seeks his own economic gain and the broker-agent earns his commission by helping the client-principal achieve that objective. Absent instructions to the contrary, the broker is thus expected to maximize the economic benefit to the client in each transaction. Hence, the duty of best execution.

"[T]he duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction." Proposed Rules, 60 Fed. Reg. at 52793; U.S. Equity Market Structure Study, Exchange Act Release No. 30,920, 57 Fed. Reg. 32587, 32595 (July 22, 1992); *see generally* Restatement of Agency (2d) § 424 (1958) (stating that agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal"). That is, the duty of best execution requires the defendants to execute the plaintiffs' trades at the best reasonably available price.[2] While there may be uncertainty in any

[2] Other terms in addition to price are also relevant to best execution. In determining how to execute a client's order, a broker-dealer should take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *See, e.g.*, Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993). When the plaintiffs state that better "prices" were reasonably available from sources other than the NBBO, I understand that to mean that, given an

particular situation as to what prices are reasonably available, the existence of a broker-dealer's duty to execute at the best of those prices that are reasonably available is well-established.

The set of prices that are reasonably available to a broker-dealer is constantly fluctuating. Therefore, determining what satisfies the duty of best execution is a highly fact-and-circumstance-sensitive inquiry, with the scope of the duty evolving over time with changes in technology and transformations in the structure of financial markets. *See, e.g.*, Final Rules, 61 Fed. Reg. at 48322-23. For example, before the creation of NASDAQ, a broker in an over-the-counter market satisfied her duty of best execution by contacting at least three market makers prior to executing a client's order. *See* Proposed Rules, 60 Fed. Reg. at 52793. With the advent of NASDAQ, and the NBBO computer system providing instant access to the best bid and offer available nationwide, the standard for satisfying the duty of best execution necessarily heightened.

The record reflects a genuine dispute of fact as to whether prices better than those on the NBBO were reasonably available from sources other than the NBBO at the time the defendants executed the plaintiffs' trades at the NBBO price. There is sufficient evidence from which a reasonable trier of fact could find, for example, that prices better than the NBBO were reasonably available on the SelectNet and Instinet at the very moment that the defendants chose to execute the plaintiffs' orders at the NBBO price. The defendants have suggested that consulting other sources besides the NBBO would have added

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evaluation of price as well as all of the other relevant terms, the trade would be better executed through a source of liquidity other than the NBBO (e.g. SelectNet, Instinet, in-house limit orders or market orders held by the defendants, or limit orders placed by the public in the Small Order Execution System). Similarly, for convenience, I use the phrase "best reasonably available price" to mean "best terms."

substantial expense and delay to the execution of plaintiffs' orders, more than offsetting any improvements that might have been available in terms of price. *See* Tr. Oral Arg. at 28-29. This, however, is clearly a factual dispute, which we are not permitted to resolve in favor of the defendants at this juncture.

I believe the evidence is sufficient to allow a reasonable trier of fact to conclude that, by the time of the class period, both technology and over-the-counter markets had developed to a point where it was feasible to maximize the economic benefit to the client by taking advantage of better prices than the NBBO.

III.

Recovery for federal securities fraud requires a showing of deliberate or reckless misrepresentation of a material fact. The misrepresentation here, according to plaintiffs, was an implied representation made by the defendants when they agreed to execute the plaintiffs' orders that they would maximize the plaintiffs' economic gain in the transaction. Plaintiffs' orders did not specify the price at which they were to be executed. It is at least a reasonable inference, plaintiffs therefore insist, that they would not have placed these orders with the defendants without an understanding that the defendants would execute them in a manner seeking to maximize plaintiffs' economic benefit. Since the defendants knew of the plaintiffs' profit motivation, they must have understood that plaintiffs would expect them to obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available. If, as plaintiffs allege, the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs, the defendants can be found to have made an implied representation that they knew to be false.

In addition to these inferences that can be drawn from an economic analysis of the plaintiffs' relationship with

the defendants, plaintiffs rely upon evidence showing that respected members of the brokerage community recognized, even prior to the class period, that trades were readily available from sources other than the NBBO and that their clients expected them to take advantage of those sources whenever it would benefit the client. *See, e.g.*, Declaration of Paul M. Lacy [A 718]; Declaration of Junius W. Peake [A 755]; Declaration of Richard Y. Roberts [A 775]. Moreover, the plaintiffs have shown that the SEC found clear evidence of a two-tiered market during the class period, in which NASDAQ market makers routinely traded at one price with retail clients like the plaintiffs and at a better price for themselves through quotation services like SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48307-08. They have further shown that the possibility that the duty of best execution might require resort to sources other than the NBBO was being actively debated during the class period and that that debate ultimately resulted, after the class period, in a regulation effectively requiring as much. *Id.*

All of this would allow a reasonable trier of fact to find that the defendants' misrepresentation—namely, that they would execute plaintiffs' trades in a manner maximizing plaintiffs' economic gain—was at least reckless, if not intentional. *See Healey v. Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (defining recklessness as an extreme departure from ordinary care). Certainly, then, scienter can be found on this record.

To be sure, as the court's opinion stresses, the defendants have countered with affidavits of other respected members of the brokerage community stating that their practice during the class period was the same as that of the defendants. This evidence could, of course, be regarded by a trier of fact as probative of the defendants' state of mind when they accepted plaintiffs' orders. But these affidavits do no more than raise a material issue of

fact as to whether the defendants knew of the expectation plaintiffs claim to have had; they do not settle the matter.

At trial, the defendants would certainly be entitled to argue to the jury that, because of industry practice, they thought their clients would expect them to execute only at the NBBO or that they never thought about their clients' expectations. Moreover, any evidence, derived from knowledge of industry practice or elsewhere, that the plaintiffs were generally aware of the defendants' exclusive reliance on the NBBO would, of course, be quite probative of whether the plaintiffs had the expectations they claim. But the court, in elevating the practice of a segment of the industry to be outcome determinative, loses sight of the fact that the basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her commission because she assists the client in reaching that goal. Based on this mutual understanding and the absence of any express limitations on the brokers' responsibility, a trier of fact could find that the defendants understood that they were expected to utilize sources other than the NBBO when a better price was readily available.

IV.

As I understand the court's analysis, a Section 10(b) defendant might be granted summary judgment even if her regular practice violated the duty of best execution, and she knew or should have known that it violated that duty, so long as she can identify a sufficient number of other broker-dealers engaged in the same wrongful conduct to be able to argue in good faith that the underlying duty was "ambiguous." I cannot accept an analysis that will produce such a result.

Even a universal industry practice may still be fraudulent. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167,

1171-72 (2d Cir. 1970) (non-disclosure of widespread industry practice may still be non-disclosure of material fact); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 676 (S.D.N.Y. 1966) (industry custom may be found fraudulent, especially on first occasion it is litigated); *see also Vermilye & Co. v. Adams Express Co.*, 88 U.S. 138, 146 (1874). Indeed, the SEC recently completed an investigation in which it found that widespread fraud was occurring in the NASDAQ market during a period overlapping the class period. *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 8, 1996).

As the court emphasizes, the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator. But neither is there any statute, rule, regulation, or interpretation, by the SEC or by a court, that authoritatively establishes that exclusive reliance on the NBBO, even when better prices are reasonably available, satisfies the duty of best execution. Whether the NBBO exhausted the category of "reasonably available prices" during the class period has thus never been expressly determined. But this did not absolve the district court of the duty to resolve the plaintiffs' securities fraud claim once it was presented in this suit.

"In the final analysis, ultimate responsibility for construction and enforcement of the securities laws must rest with the court." *Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) para. 94,445, at 95,540, 1974 WL 377 (S.D.N.Y. Mar. 15, 1974). The district court was not deprived of this enforcement authority just because no court or regulator had previously chosen to exercise such authority with respect to the practice challenged here. *See, e.g., Chasins*, 438 F.2d at 1171-72 (finding that defendant's failure to disclose its market maker status was material omission under Section 10(b), despite fact that SEC had never previously held that such disclosure was required).

V.

On the record before us, I believe a reasonable trier of fact could conclude that the defendants misrepresented that they would execute the plaintiffs' orders so as to maximize the plaintiffs' economic benefit, and that this misrepresentation was intentional or reckless because, at the time it was made, the defendants knew that they intended to execute the plaintiffs' orders at the NBBO price even if better prices were reasonably available. A reasonable trier of fact could find scienter with respect to a material misrepresentation, as well as the other elements essential to a Section 10(b) fraud claim. Accordingly, I must respectfully dissent.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX C

Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, 911 F. Supp. 754 (Dec. 15, 1995)

[Filed Dec. 15, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*
SECURITIES LITIGATION

OPINION

Debevoise, Senior District Judge.

This is a class action in which the complaint charges defendant brokerage firms with securities fraud in violation of Section 10 of the Securities Exchange Act of 1934 and Rule 10-b promulgated thereunder, as well as breach of fiduciary duty and unjust enrichment under state law. Defendants moved to dismiss the complaint for failure to state a claim upon which relief can be granted. At the direction of the court defendants' motion was converted into a motion for summary judgment. Defendants were requested to supply by way of affidavit and supporting documents information relating to each transaction which they conducted on behalf of each of the plaintiff class representatives during the class period. In addition, each party was requested to submit information about market practices and regulatory requirements or advisories concerning transactions such as those which were the subject of the complaint. For the reasons given below, defendants' motion for summary judgment is granted.

I—PLAINTIFF'S ALLEGATIONS

Defendants in this case, Merrill Lynch Pierce Fenner & Smith, Inc. ("Merrill Lynch"), PaineWebber, Inc. ("PaineWebber") and Dean Witter Reynolds, Inc. ("Dean Witter"), are "integrated broker/dealer" brokerage companies that transact trades both as agents and as principals. Plaintiffs Bruce Zakheim IRA FBO Bruce Zakheim ("Zakheim"), a Merrill Lynch customer, Gloria Binder ("Binder"), a Painewebber customer, and Jeffrey Phillip Kravitz ("Kravitz"), a Dean Witter customer retained defendants to either conduct trades on their behalf or to trade with them directly in various over-the-counter ("OTC") securities.

The gravamen of plaintiffs' complaint is as follows:

1) As agents, defendants relied exclusively on the National Best Bid and Offer ("NBBO"), a price quotation representing the best bid and best offer of any OTC market maker in a particular security on the two-sided NASDAQ market, to fulfill their duty to execute their customers' market orders [1] at the best available price, despite the availability of better prices from a number of sources of liquidity. Those sources included SelectNet [2], Instinet [3], in-house limit orders, in-house market orders, and the SOES limit order file.[4] Plaintiffs contend that by failing to take advantage of these other sources and by failing to disclose such neglect, defendants breached a

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[1] An instruction from a retail customer to buy or sell securities at the best available market price that is distinguished from a "limit order," an instruction to buy or sell at a particular price, specified by the customer.

[2] An on-line trading system provided by NASDAQ. *See infra* at p. 10.

[3] Institutional Networks, Inc., a proprietary on-line trading system. *See infra* at p. 11.

[4] Small Order Execution System Limit-Order Service. *See infra* at p. 12.

fiduciary duty they owed to plaintiffs by dint of the broker/customer relationship that existed between them. Amended and Consolidated Class Action Complaint ("Amended Complaint") ¶¶ 25-32, 46-49.

2) As principals, defendants not only failed to execute plaintiffs' market orders at the best available price but also employed a number of fraudulent devices to secretly accrue profits for themselves. Failure to disclose both the accrual of such profits and the practice of failing to execute at the best available price, according to plaintiffs, amounted to fraud, Amended Complaint ¶ 42, and a further violation of defendants' fiduciary duty. Amended Complaint ¶ 48. Moreover, defendants were unjust enriched by the accrual of secret profits. Amended Complaint ¶¶ 50-53.

The parties agree that all the transactions in question here were executed by defendants, either as agents or principals, at prices that were equivalent to the NBBO at the time of each transaction. Amended Complaint ¶ 28; Memorandum of Law In Support of Defendants' Motion to Dismiss the Amended Complaint at 7-8; Reply in Support of Defendants' Motion To Dismiss The Amended Complaint at 2; Declaration of Hugh Quigley ¶ 10; Affidavit of Robert Slane ¶ 9; Affidavit of Thomas Dwyer ¶¶ 6-8.

The fraudulent devices alleged by plaintiffs to have been employed by the defendants in their role as principals, are as follows:

> 1) *Failure to reference sources other than the NBBO when setting prices, as principals, for transactions with retail customers:* By setting the price of their transactions as principals with reference exclusively to the NBBO, defendants arbitrarily made parity with the NBBO the de facto standard for best execution. Because prices superior to the NBBO, from the standpoint of the retail customer, were in

fact available from other sources of liquidity at the time of those transactions, defendants were able to establish market positions, both long and short, that were, in fact, better, from their standpoint, than those that represented the "best available price" at any given time. By establishing such superior positions, defendants were able to profit from the difference between the NBBO and the best available price. Amended Complaint ¶ 33.

2) *Failure to cross in-house market orders:* Plaintiffs contend that when defendants received contemporaneous market orders to buy and sell shares in the same stock they systematically failed to execute those orders at a price between the bid and ask, executing each instead at the NBBO quote, thereby appropriating the "spread" between the bid and asked prices on the two-sided NASDAQ market while incurring no risk to themselves. Amended Complaint ¶¶ 34-35.[5]

3) *Failure to cross customers' market orders with in-house limit orders:* Plaintiffs contend that defendants executed customers' market orders at the NBBO despite having received corresponding "limit" orders in the same security from other customers. Defendants thereby appropriated the "spread" while incurring no risk to themselves. Amended Complaint ¶ 36

4) *Failure to cross customers' market orders with SOES limit orders:* executing orders to either sell or

[5] Plaintiffs distinguish between situations in which balanced numbers of buy and sell orders are received, Amended Complaint ¶ 34, and situations in which unbalanced orders were received, *Id.*, ¶ 35. The same failure to cross market orders is alleged in both cases. The difference is that in the unbalanced case, defendants are alleged to have taken advantage of another fraudulent device, using the NBBO rather than a better available price on SelectNet or Instinet, with respect to the remaining shares.

buy shares of particular stocks at the NBBO despite the currency of "limit" orders on the SOES limit order file.[6]

5) *Re-trading at the inside price on the "same side" of the spread:* executing market orders to either sell or buy shares of particular stocks at the NBBO quotes despite better prices being available, and then immediately retrading those same shares at those better prices for defendants' own profits, incurring no risk by trading on the same side of spread. Amended Complaint ¶ 37.

6) *Selling order flow:* Without knowledge or consent of the customers placing the orders and in exchange for payments ("payment for order flow"), defendants allegedly routed plaintiffs' market orders to other brokers who failed to execute them at the best available price and who used one or more of the above fraudulent devices to secretly accrue profits to themselves. Amended Complaint ¶ 38.

Plaintiffs bring this class action pursuant to Fed. R. Civ. Proc. 23 on behalf of all those persons who placed market orders with Merrill Lynch, PaineWebber or Dean Witter to purchase or sell shares of OTC stock between November 4, 1992 and November 4, 1994.

II—MARKET OPERATION

NASDAQ

Over-the-counter trading ("OTC") is, in a sense, the oldest and simplest type of economic exchange: buyer

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[6] This device was not alleged in the Amended Complaint. Plaintiffs introduced it in papers supplied in compliance with the court's order converting the motion to dismiss into a motion for summary judgment. Plaintiffs' Supplemental Memorandum at 5; Declaration of Haim Mendelson, ¶ 17(iv) at 9.

and seller meet outside a formal marketplace, agree on a price and exchange items of economic value. The term derives from a time, long before the advent of computers and electronic communications networks, when some trading in stocks took place in banks where the physical certificates were passed "over-the-counter." *Reshaping The Equity Markets,* Robert A. Schwartz at 47 (Harper-Business 1991) [hereinafter Schwartz].

In 1971, in an effort to link together geographically dispersed dealers into a single integrated system by exploiting rapidly evolving technologies, Congress created the National Association of Securities Dealers Automated Quotation System ("NASDAQ,", more formally the Nasdaq Market System, Inc.), a subsidiary of The National Association of Securities Dealers ("NASD"). The purpose of the NASDAQ was explicitly delineated in the authorizing legislation:

> The securities markets are an important national asset which must be preserved and strengthened . . . The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

15 U.S.C. § 78k-1(a)(1)(A) and (D).

The function of a stock exchange is to provide an environment in which the transfer of capital between enterprises can be accomplished at fair prices for minimal cost. One measure of the success of an exchange in fulfilling that role, known as liquidity, is the rapidity and ease with which such transfers can be effectuated. An marketplace with good liquidity affords buyers and sellers the opportunity to locate counterparts willing to trade a wide range of issues at acceptable prices as quickly and efficiently as possible.

In contrast to traditional markets, where liquidity, and thus efficiency and immediacy, are maintained by monopolist "specialists," liquidity on the NASDAQ is maintained by competing dealers, known as "market makers," who hold themselves out to all comers as ready to buy or sell a security for their own account. By making known the price at which they are willing to transact in a particular stock, NASDAQ market makers create a competitive structure in which fair prices are arrived at quickly and efficiently.

To maintain this liquid environment market makers must put their own capital at risk. In order to "foster the risk-taking function of market makers and thereby . . . provide free market incentives to active participation in the flow of orders," *Securities Acts Amendments of 1975*, Report of the Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. at 12 (1975), market makers are therefore permitted to buy securities at a "bid" price and to sell them at a higher "ask" price, thus creating what is known as a "two-sided" market. *Plastis v. E.F. Hutton*, No. G86-1030 CA5, 1990 U.S. Dist. LEXIS 4828 (W.D. Mich. Apr. 18, 1990) ("The difference between [the bid and offer] is known as the 'spread,' and represents the market maker's compensation for the transaction."); *Investors Research Corp.*, 1976 SEC LEXIS 2771 (July 19, 1976) ("The spread is [the market maker's] compensation for 'dealing' in a security and risking its capital.").

The NBBO

SEC rules require that any NASDAQ dealer that wishes to hold itself out as a market maker in a particular security must continually report the prices at which it is willing to buy and sell the security. 17 C.F.R. § 240.11Ac1-1 (c)(1). Once reported, those quotes must be honored up to the "quotation size" ("[t]he number of shares . . . that [a market maker] is willing to buy at the bid price or sell

at the offer price comprising his bid or offer. . ." 17 C.F.R. § 240.11Ac1-1(a)(10)), 17 C.F.R. § 240.11Ac1-1(c)(2).

NASDAQ itself is required to "collect, process and make available . . . the highest bid and lowest offer communicated . . . by each member . . . acting in the capacity of an OTC market maker for each reported security . . ." 17 C.F.R. 240.11Ac1-1(b)(1)(ii). This quotation has come to be known as the National Best Bid and Offer ("NBBO").

In accordance with this obligation, NASDAQ operates a quotation reporting system which disseminates market maker quotes over an electronic communications network. There are three levels to this service:

> Level 1—Displays the best bid and ask quotes, high, low and last prices and volumes. Does not reveal origin of quotes.
>
> Level 2—Displays the current quotes and the names of the market makers who have entered them.
>
> Level 3—Displays the same information as Level 2 and also allows market makers to enter and to update their quotes.

SelectNet

Introduced in November, 1990, SelectNet is an on-line service provided by NASDAQ on which subscribers can negotiate trades and execute orders in OTC securities. In addition to price, offers posted by subscribers can specify size, the period during which the offer is "open," (any period up to 99 minutes or an entire day), and whether the price or size of an order is negotiable. Subscribers may also "preference" their orders, that is, an order may be directed at a specific market maker, at all market makers, or at all subscribers. Offers may be accepted, countered or declined. Subscribers who are not market makers

may make their offers anonymously. Market makers must identify themselves.

The thrust of the SelectNet service is to provide an electronic alternative to negotiation by telephone. "The system is offered to NASD members to facilitate negotiation of securities transactions through computer automation, rather than relying on telephone communication." *Market 2000, An Examination of Current Equity Market Developments*, Division of Market Regulation of the SEC, Section IV at 6-7, 1994 SEC LEXIS 135 at *8 (1994) (hereinafter *Market 2000*)

Instinet

Institutional Networks, Inc. ("Instinet") is another online trading system, similar to SelectNet but differing in two important aspects: 1) it is privately owned and operated; and 2) subscribers, including market makers, may display offers and trade *anonymously*. Traders, particularly large institutions, may therefore conduct large transactions without any revelation of their identity that might induce market reaction against their interest. Orders are accepted from a minimum of 1000 shares to a maximum of 50,000 shares. Although it conducts trades on behalf of clients, Instinet is not a market maker and therefore does not risk its own capital, charging only a commission for its services. *Instinet Corp.*, SEC No-Action Letter, 1992 WL 672345 (S.E.C.) at *2.

SOES Limit Order File

In response to the general sentiment that retail customers were not obtaining execution at the best possible price, the SEC created the Small Order Execution System ("SOES") in December, 1984. Participation in SOES was made mandatory for market makers after the October 1987 crash. Sec. Ex. Act Rel. 25,791, 42 SEC Dock. 91 (1988); Sec. Ex. Act Rel. 26,650, 43 SEC Dock. 790 (1989). Automatic execution on SOES provides small

cusotmers with the opportunity to consistently obtain the NBBO by automatically routing orders to the market maker with the best posted bid or offer.

In January, 1989, the SEC introduced the Limit-Order Service, an extension of SOES. The SOES limit book file, as this service came to be known, allows both GTC (good till canceled) and day limit orders of one thousand shares or less to be accepted, stored, and automatically executed when a market maker's quote reaches or exceeds a limit order price. A small customer can therefore be assured of obtaining execution at a given price if the market, in the form of the NBBO, reaches that level.

In-house limit and market orders

Individual integrated firms, functioning as either agents or principals, receive orders to both buy and sell securities in the course of the trading day. When either a limit or market order is received before a "corresponding" order is executed, the possibility exists that the two orders could be matched, or "crossed" at a price midway between them. "Call market" trading systems employed in some foreign countries, e.g., Austria, Belgium, Germany and Israel, as opposed to "continuous" trading systems employed on the United States financial markets (both securities exchanges and the OTC markets), regularly utilize this type of order crossing by periodically batching corresponding offers for simultaneous execution at a single "clearing" price:

> "[O]rders for an issue are revealed to an auctioneer when the market is called. Buy and sell orders are matched at the price that most closely equates the aggregate number of shares offered for sale (at that price and below) with the aggregate number of shares sought for purchase (at that price and above). Then, all market orders to buy and all buy limit orders at the clearing price or higher are executed, as are all market orders to sell and all sell limit orders at the clearing price or lower."

Schwartz at 181.

It is the contention of plaintiffs in this action that defendants were obligated to conduct such a call market whenever an outstanding market or limit order remained unexecuted upon receipt of corresponding market order. Amended Complaint ¶¶ 34-36.

Duty of Best Execution

The relationship between a broker/dealer and its customer gives rise to "certain fiduciary obligations." *In re E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, 89,326 at 89,328 and n.9 (July 6, 1988) (citing Restatement (Second) of Agency ¶ 1 (1957)). Amongst those obligations is a duty to execute the customer's order at the best available price. *Payment For Order Flow*, Exchange Act Release No. 34902 [1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,444, 85,849 at 85,854 n.28. ("*Payment for Order Flow Release No. 34902*"). That agency obligation, moreover, does not dissolve when the broker/dealer acts in its capacity as a principal. "A broker/dealer's determination to execute an order as a principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'" *In re E.F. Hutton* at 89,328 (quoting *Opper v. Hancock Securities Corp.*, 250 F.Supp. 668, 675 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966)). Avoidance of any conflict of interest is central to public confidence in the various markets. "The integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed." *The Report Of The Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 624 (1963).

The central issue in this case is precisely what is entailed by the duty of best execution. Any act done in good

faith in conformity with an SEC rule cannot result in liability under Section 10 (Manipulative and Deceptive Devices and Contrivances). 15 U.S.C. § 78w(a)(1) ("No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . [or] any self-regulatory organization . . ."). The Second Circuit has extended this doctrine to the Commission's interpretations of its own rules. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1294 (2d Cir. 1973). Failure to comment or a no-action letter from the SEC does not constitute an interpretation by the Commission. *SEC v. Falstaff Brewing Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 96,583, at 94,473 (D.D.C. 1978), *aff'd* 629 F.2d 62 (D.C.Cir.), cert. denied sub nom. *Kalmanovitz v. SEC*, 449 U.S. 1012 (1980); *Langert v. Q-1 Corp.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. § 94,445, at § 95,540 (S.D.N.Y. 1974).

The difficulty here is that neither Congress, the SEC nor the NASD has issued a definitive statement on point concerning the use of the NBBO as statisfaction of the duty of best execution.[7] Lacking such a pronouncement, the parties rely on various sources of to bolster their respective interpretations of the content of that duty as it existed during the class period.

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[7] Plaintiffs fail to allege any damage based on their "cross trades" theories. *See infra* at pp. 27-28. Accordingly, the discussion here is confined to those counts of the Amended Complaint that concern adherence to the NBBO. Amended Complaint ¶¶ 30-33, 37 and 39-53.

The theory of damage contained in Count 38 of the Amended Complaint, concerning payment for order flow to firms that allegedly were guilty of the same fraudulent conduct as defendants, is dependent on plaintiffs' primary theories of damage. Accordingly, the discussion here is confined to the underlying damage theories.

Defendants' Best Execution Sources

In support of their contention that the duty of best execution is categorically satisfied by reference the NBBO defendants cite the following sources:

1) The NASD Manual: "In any transaction for or with a customer, a [broker-dealer] . . . shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing conditions." *Interpretation of the Board of Governors on Execution of Retail Transactions in the Over-The-Counter Market,* NASD Rules of Fair Practice, Art. III, Section 1, NASD Manual (CCH) ¶ 2151.03.

Defendants contend that the NASDAQ Level 2 was the "best inter-dealer market" and the NBBO was the most favorable "resultant price." Memorandum of Law In Support of Defendants' Motion To Dismiss The Amended Complaint at 18.

2) An investigatory report compiled by the SEC's Division of Market Regulation: "[I]t is reasonable to accept quote-based executions of market orders based on the NASDAQ best bid or offer as consistent with best execution, absent customer instructions to the contrary." *Market 2000,* Study V at 5, 1994 SEC LEXIS 136 at *15.

3) An SEC regulation on the SOES system: "SOES orders are executed in rotation against [] market makers at the inside bid or ask." *Self-Regulatory Organization; National Association of Securities Dealers, Inc.,* Exchange Act Release No. 34-33377, 58 Fed. Reg. 69419 (Dec. 23, 1993). Defendants contend that SEC sanction of the SOES system, with its automatic execution at the NBBO, implies SEC approval of use of SOES to satisfy best execution. Defendants' Memorandum Of Law In Support Of Motion To Dismiss at 21. Plaintiffs counter that use of

SOES satisfies best execution only when a broker/dealer has diligently ascertained that a better price is not available: "[A] broker-dealer routing customer orders for automated execution could satisfy its best execution obligations so long as the broker-dealer assesses periodically the quality of competing markets . . ." Plaintiff's Memorandum Of Law In Opposition To Defendants' Motion To Dismiss The Amended Complaint at 33-34 and *Payment For Order Flow Release No. 34902* at 85,854.

4) A report to the Board of Governors of the NASD: "[The committee] believes that when orders are executed at the best current displayed bid or offer that investors receive best execution of their small-sized orders. . ." *Inducements for Order Flow,* A Report to the Board of Governors, National Association of Securities Dealers at 28 (July 1991). Plaintiffs contend the SEC expressly disavowed this statement, noting that "such interpretation of best execution in all circumstances may not be consistent with previous statements of the Commission regarding best execution." *Payment for Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, at 84,542 n.29 (Oct. 6, 1993).

5) The affidavit of the General Counsel of the NASD: "The NASD has viewed [execution at the NBBO] as consistent with the duty of 'best execution' that broker-dealers assume when they accept customer orders" Declaration of T. Grant Callery, ¶ 4. "The NASD has not in the past adopted any rules that required market makers to 'cross' market orders with in-house limit orders rather than execute those orders at the NBBO The NASD also has not required market makers to seek execution of market orders at prices reflected in the Instinet or SelectNet system." *Id.*, ¶ 5.

6) The affidavit of a former chairman of the SEC: "It has long been the understanding in the securities industry that investors receive best execution when their small OTC orders are executed at the NBBO. It is the

general custom and practice of firms in the industry to execute such orders at the NBBO." Affidavit of David S. Ruder, ¶ 3.

Plaintiffs' Best Execution Sources

In support of their contention that defendants were obligated to look beyond the NBBO when satisfying the duty of best execution which they owed to their retail customers, plaintiffs cite the following:

1) An SEC report to Congress: "For a firm which executes customer orders from an inventory accumulated in the course of making a market . . . its obligation in checking markets involves reasonably assuring that the customer pays or receives a net price not disadvantageous in respect of the price available elsewhere." *The Report Of The Special Study of Securities Markets,* H.R. Doc. 95, 88th Cong., 1st Sess. Pt. II, 616 (1963).

2) Two SEC regulations regarding payment for order flow: "[While] brokers have not been held . . . to an absolute requirement of achieving the most favorable price on each order[,] [w]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible given all the facts and circumstances." *Payment For Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, 84,536 at 84,541 (Oct. 6, 1993) (quoting *Second Report on Bank Securities Activities: Comparative Regulatory Framework Regarding Brokerage-Type Services* 97-98, 98 n.233 (Feb. 3, 1977) *as reprinted in* Senate Comm. on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess., *Report on Bank's Securities Activities of the SEC* 145, 251-52, 252 n.233 (Comm. Print 1977).

"[T]he Commission's staff recently has warned against presuming that guaranteed executions at the best bid or offer always will satisfy the broker-dealer's best execution duties for small orders in listed securities." *Payment For*

Order Flow Release No. 34902 at 85,849 (referring to *Market 2000*, Study V at 4).

3) An NASD Notice to Members: "[I]f the market maker executes trades immediately surrounding its retail sales, such as comparable sales to a non-market maker at a price lower than the inside ask, the use of these actual sale prices may be required to arrive at the prevailing market price." *Special NASD Notice to Members Re: Policies and Procedures For Markups,* 1992 NASD LEXIS 47 at *14 (Apr. 1, 1992).

4) The affidavit of a former member of the Board of Governors of the NASD: "[I]t is my understanding and opinion that a broker-dealer's execution of a customer market order at the NBBO when superior prices are otherwise reasonably available does not comport with the duty of best execution." Declaration of Junius W. Peake, ¶ 5.

5) The affidavit of a former Commissioner of the SEC: "It is my opinion, during the Class Period, absent customer instructions to the contrary, a broker-dealer failed to fulfill its duty of best execution to a customer if the broker-dealer did not execute the customer's order at a reasonable available superior price, including such a price available on Instinet or SelectNet . . . and instead executed the order at the NBBO." Declaration of Richard Y. Roberts, ¶ 7.

6) The affidavit of a retired OTC securities trader: Paul M. Lacy was an over-the-counter trader for thirty-two years prior to his retirement in 1990. "[I]n order to meet [the fiduciary obligation to obtain the best price available], before I executed any market order for a retail customer to buy or sell OTC securities in which [my employer] made a market, in addition to monitoring the NBBO price displayed on NASDAQ, it was my custom and practice to check prices available from alternative sources including (1) any open orders for that security;

(2) any day orders for that security; (3) other in-house market orders for the same security that could be crossed; and (4) contacts with fellow traders at competing broker-dealers firms . . . Beginning in the late 1980's . . . I began also to check Instinet quotations prior to executing any retail customer market orders to buy or sell the NASDAQ stocks in which I made a market." Declaration of Paul M. Lacy, ¶¶ 5 and 8.

The parties contentions notwithstanding, none of these sources represents a law, regulation or interpretation of a regulation which directly addresses the question of whether or not a broker/dealer's duty of best execution was satisfied by exclusive reference to the NBBO during the class period. While these statements may be helpful, absent an unequivocal pronouncement on point, it must be independently determined whether circumstances as they existed during the class period imposed a standing obligation on the defendants to refer to sources other than the NBBO in fulfilling the duty of best execution that they owed to plaintiffs, and, if so, whether failure to refer to such other sources, *ipso facto,* constituted securities fraud.

III—PROPOSED RULES ANNOUNCED SUBSEQUENT TO THE CLASS PERIOD

SEC Proposed Rules—Order Execution Obligations

Both parties point to the recent release of a set of proposed rules by the SEC in support of their interpretation of broker obligations existing during the class period.

On September 29, 1995, the SEC proposed rules that would amend Rule 11Ac1-1 to require market makers to include "any better prices that they quote privately through certain electronic communications networks" in their best bid and offer quote. "The [proposed] amendments are designed specifically to address what the Commission believes to be the potential for market makers to quote one price to public investors but to publish firm quotes in

private systems at better prices." *Order Execution Obligations—Proposed Rules,* SEC Release No. 34-36310 at 22, (Sept. 29, 1995) (hereinafter *Order Execution Obligations*).

The proposed rule does not directly comment on satisfaction of the duty of best execution through use of the NBBO. "The rules proposed today . . . are not intended to alter or displace the well-established duty under the antifraud principles for market participants to provide customers with best execution." *Id.* at 10. Instead, the intended effect is achieved by modifying the NBBO itself: reference to the "new" NBBO will produce prices equivalent to the best available prices the broker/dealer is offering not only on the NASDAQ Level 2, but on SelectNet and Instinet. *Id.* at 22.

The proposed rule is explicitly prospective. "The Commission is proposing to include *prospectively* within the definition of 'bid' or 'offer' under the Quote Rule priced orders that market makers enter into widely disseminated electronic communications networks, thereby requiring market makers to include such orders in the bids and offers they communicate to their exchange or association for reflection in their published quotations." *Id.* at 24.

Also included in the proposed rule is a requirement that exchange specialists and OTC market makers include in-house customer limit orders in the determination of their published quotes. *Id.* at 40. By requiring dealers to "expose" their customers' limit orders, thereby incorporating them into the NBBO, the SEC has proposed to implement a practice which plaintiffs contend defendants were obligated to follow during the class period. Amended Complaint ¶ 36.

NASD Proposed Rule—NAqcess

Plaintiffs also point to the release of a proposed rule change by the NASD, seeking to set up a small order

execution system to supersede SOES. The new system, entitled "NAqcess," would provide greater protection for the public's limit orders and afford public market orders the opportunity for price improvement, the ability to transact "between the spread" at purchase prices lower than the inside "ask" price, and sale prices higher than the inside "bid" price, by allowing customers to specify that an order be entered into NAqcess where it would interact with other limit and market orders without the participation of a market maker. *Proposed Rule Change*, File No. SR-NASD-95-42, National Association of Securities Dealers at 3-4 (Sept. 18, 1995).

The proposed rule parallels plaintiffs contention that defendants should have allowed in-house limit and market orders to interact without defendants' participation. Amended Complaint ¶¶ 34-36.

Defendants assert that the prospective nature of both pronouncements is supportive of their contention that no obligations similar to those described in the new rules existed prior to their proposal by the SEC and NASD. Defendant PaineWebber's Supplemental Brief In Support Of Motion For Summary Judgment at 14-16.

IV—SPECIFIC TRANSACTIONS

Thirteen trades were conducted by defendants on behalf of plaintiff class representatives during the class period. The details of those transactions are as follows:

Trans. Date	*Defendant*	*Plaintiff*	*Role*	*Type*	*Shares*	*Security*	*Price*
Aug 19, 1993	PaineWebber	Binder	agent	purchase	7000	Hydron Tech.	2 9/16
Apr 21, 1994	PaineWebber	Binder	agent	purchase	1000	Optical Radiation	20
July 18, 1994	PaineWebber	Binder	agent	sale	1000	Optical Radiation	22 1/4
Nov 10, 1993	Dean Witter	Kravitz	agent	purchase	100	Cellular	28
Nov 10, 1993	Dean Witter	Kravitz	agent	sale	262	IDB Comm.	45
Oct 20, 1993	Dean Witter	Kravitz	agent	purchase	100	Iwerks	34 3/4
Sept. 21, 1994	Dean Witter	Kravitz	agent	purchase	100	Safety Components	19
Aug 25, 1993	Dean Witter	Kravitz	agent	purchase	100	Scientific Games	18
Feb 11, 1994	Dean Witter	Kravitz	agent	purchase	100	Simpson Industries	22 1/2
Feb 1, 1994	Dean Witter	Kravitz	princ.	purchase	100	Envoy	19 1/4
Dec 29, 1993	Dean Witter	Kravitz	princ.	sale	100	Spectrum	7 1/2
June 7, 1994	Merrill Lynch	Zakheim	princ.	purchase	120	US Healthcare	42 3/4

Defendants acted as market makers in three of the thirteen transactions: plaintiff Kravitz's Feb. 1, 1994 and Dec. 29. 1993 transactions with Dean Witter and plaintiff Zakheim's June 7, 1994 transaction with Merrill Lynch. The remaining ten transactions were conducted by defendants as agents. Only those counts of the complaint which address defendants' conduct as agents, that is, those counts that allege failure to obtain the best available price and the fraudulent sale of order flow to market makers who in turn derived secret profits, Amended Complaint ¶¶ 30-31 and 38, are applicable to the remaining ten transactions.

Damage (if the plaintiffs' theory of liability is accepted) is definitively shown in only one transaction:

Plaintiff Binder's April 21, 1994 purchase order for 1000 shares of Optical Radiation was placed by defendant PaineWebber, as agent, with Prudential Securities, a market maker in Optical Radiation stock. Affidavit of Thomas Dwyer, ¶¶ 2 and ¶ 7. Prudential entered the order at 14:22:54 and executed the transaction approximately 6 minutes later, at 14:29:00, for a price of 20. *Id.*, Exhibit 2 at 1. A "day" offer, that is, an offer that is good for the entire trading day, to sell 2000 shares of Optical Radiation in blocks of 1000 shares at 19¾ was broadcast on SelectNet to all market makers in that security at 10:19:06. Certification of Karen L. Barr, Exhibit A at page "2357." As a day order broadcast to all market makers, that order was available to Prudential Securities. Because Prudential executed Binder's order at the NBBO of 20 rather than accepting the open SelectNet day offer at 19¾, Binder was charged ¼ more per share than she would have had the SelectNet offer been accepted. The resulting net damage was $25 on the 1000-share transaction. Failure to disclose the routing of a market order to another brokerage firm that executed the order at the NBBO while a superior price was available on SelectNet constitutes the type of conduct which plaintiffs allege is a fraud. Amended Complaint ¶¶ 31 and 38.

In two other transactions there is evidence of damage of a more indirect, somewhat speculative nature:

1) Plaintiff Binder's August 19, 1994 purchase order for 7000 shares of Hydron Technologies was placed by defendant PaineWebber with Reich & Co., a current market maker in Hydron Technologies. Affidavit of Thomas Dwyer, ¶¶ 2 and 6. Reich & Co. entered the order at 13:31:00 and executed it approximately 17 minutes later at 13:48:28 at a price of 2 9/16. *Id.*, Exhibit 2 at 2. An offer preferenced to Lehman Bros. (and therefore not available to Reich & Co.) to sell any quantity of Hydron Technologies up to 3000 shares at a price of 2½ was entered on SelectNet at 13:30:32. The offer was good for three minutes. Certification of Karen L. Barr, Exhibit A, page "1338." Plaintiffs contend that the existence of the Lehman Bros. offer, although not available to Reich & Co. should have served as the reference price by which Reich set the price of its own transaction with Binder. "[T]he contemporaneous availability of a superior price on SelectNet, although not available for Binder's order, indicates that a superior price may have also been available on Instinet." Reply Declaration of Haim Mendelson, ¶ 33 at 13-14. The differential of 1/16 between the NBBO and preferenced SelectNet price resulted in net damage to Binder of $437.50 on the 7000-share transaction.

2) Plaintiff Zakheim's June 7, 1994 purchase order for 120 shares of U.S. Healthcare was executed by defendant Merrill Lynch, as principal, at 11:11:54 for a price of 42¾. Twenty-nine of Merrill Lynch's thirty-four trades in USHC conducted on June 7, 1994 on Instinet were executed at prices better than NBBO. Reply Declaration of Haim Mendelson, ¶¶ 10-11 at 6-7. The average price improvement over these thirty-four transactions was $0.16 per share. Plaintiffs contend that this creates an inference "that it is more likely than not that a better price was available on Instinet between the times Merrill Lynch re-

ceived and executed Mr. Zakheim's order." Id., ¶ 12 at 7. Based on the average price improvement demonstrated in the thirty-four transactions, Zakheim's damage was $19.20 on the 120-share transaction.

With respect to this June 7, 1994 transaction, plaintiffs allege an additional theory of damage. No in-house market orders were available for crossing with Zakheim's market order at or about the time this trade was executed. Reply Declaration of Haim Mendelson, ¶ 14 at 7. Plaintiffs contend, however, that market orders of other Merrill Lynch customers could have been crossed with each other at the start of trading on the same day. For example, two unexecuted market orders to buy 450 shares in total and two unexecuted market orders to sell 305 shares in total were held by Merrill Lynch as of 9:27:35 on June 7, 1994. Plaintiffs contend that 305 shares could have been exchanged at a price midway between the respective offers at that time without Merrill Lynch's participation in the current spread. *Id.*, ¶¶ 15-16 at 8. At the time, the NBBO bid price was 41½ and the NBBO ask price was 41¾, yielding a spread of ¼. Zakheim's loss under this theory is based on one-half of the spread which Merrill would have gained by selling to Zakheim at the NBBO asking price rather than crossing his order with another in-house market order, had one been available, at a price midway between NBBO bid and ask. The resultant damage calculation is $15 on the 120-share transaction. This damage theory fails to recognize that widely accepted principle, noted by plaintiffs themselves, Plaintiff's Memorandum In Opposition at 43, n.32, that class representatives cannot rely upon injury to absent class members but must allege personal injury. *Warth v. Seldin,* 422 U.S. 490, 493 (1975); *Cent'l Wesleyan College v. W.R. Grace & Co.*, 6 F.3d 177, 188 (4th Cir. 1993); *Casey v. Lewis,* 4 F.3d 1516, 1519 (9th Cir. 1993); *Griffin v. Dugger,* 823 F.2d 1476, 1482 (11th Cir. 1987), *cert. denied,* 486

U.S. 1005 (1988); *Brown v. Sibley*, 650 F.2d 760, 771 (5th Cir. 1981).

No information on either Instinet prices [8], SOES limit order file prices or payment for order flow arrangements was supplied for any of the transactions.

Data on contemporaneous Selectnet prices were supplied in six other transactions [9] but no available superior price was shown in any of them. For example, on Sept. 21, 1994, the day of plaintiff Kravitz's 100 share purchase of Safety Components executed by Dean Witter as agent at a price of 19, three SelectNet offers for Safety Components were posted:

1) At 10:18:28 an offer to sell any quantity of 600 shares or less at a price of 18¾, good for three minutes,

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[8] Merrill Lynch provided a "TMTR Trade Report" showing "the time and place of transactions by all market makers in U.S. Healthcare at or around the time of [plaintiff Zakheim's June 7, 1994] transaction." Declaration of Hugh Quigley, ¶ 5. Although some of those transactions took place on Instinet, "[b]ecause of the NASD reporting rules, a large number of transactions executed through Instinet will not [be labelled as such in] the TMTR Trade Report and hence will not be identifiable as Instinet transactions." Reply Declaration of Haim Mendelson, ¶ 8(b) at 5. Thus although some Instinet information is provided in this TMTR Trade Report, it is incomplete no inference on contemporaneous Instinet activity can be drawn.

[9] July 18, 1994 (Binder sale of 1000 shares of Optical Radiation through PaineWebber as agent);

Oct. 20, 1993 (Kravitz purchase of 100 shares of Iwerks Entertainment through Dean Witter as agent);

Sept. 21, 1994 (Kravitz purchase of 100 shares of Safety Components through Dean Witter as agent);

Feb. 11, 1994 (Kravitz purchase of 100 shares of Simpson Industries through Dean Witter as agent);

Feb. 1, 1994 (Kravitz purchase of 100 shares of Envoy CP with Dean Witter as principal); and

Dec. 29, 1993 (Kravitz sale of 100 shares to Spectrum Information Technologies to Dean Witter as principal).

was broadcast to all market makers. The offer was accepted (for all 600 shares at the offered price) at 10:19:21.

2) At 11:07:11 an offer to sell any quantity of 600 shares or less at a price of 18½, good for three minutes, was broadcast to all market makers. The offer was accepted (for all 600 shares at the offered price) at 11:07:25.

3) At 15:39:41 an offer to purchase exactly 1000 shares at a price of 17¾, good for three minutes, was broadcast to all market makers. The offer was withdrawn nineteen seconds later at 15:40:00 without being accepted.

At the time the Kravitz's order was executed by Dean Witter on the SOES system, 13:10, none of the day's three SelectNet orders were open and available. Therefore, with respect to SelectNet, plaintiff Kravitz suffered no damage in this transaction. It is conceivable, but not established, that Instinet or the SOES limit order would show better prices in the transactions for which SelectNet data was supplied as well as in the remaining three transactions [10] for which no information on any alternative sources of liquidity was provided.

According to plaintiffs, "[T]hroughout the Class Period [November 4, 1992 to November 4, 1994], each Defendant *daily* took *tens of thousands* of relatively small orders from their respective retail customers, including Plaintiffs and members of the Class, to buy and sell *tens of millions* of shares of stock." Amended Complaint ¶ 25 (emphasis added). The foregoing examples of just a few of plaintiffs'

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[10] Nov. 10, 1993 (Kravitz purchase of 100 shares of Cellular through Dean Witter as agent);

Nov. 10, 1993 (Kravitz sale of 262 shares of IDB Communications through Dean Witter as agent); and

Aug. 25, 1993 (Kravitz purchase of 100 shares of Scientific Games through Dean Witter as agent).

transactions suggest i) that determining damages under plaintiffs' theory would be no easy task and, ii) more important, the additional inquiries which would have to be made when executing each defendant's tens of thousands of daily relatively small orders might be so time consuming and burdensome that customers would be prejudiced through the inability of broker/dealers to execute customer orders in a timely and inexpensive manner. These considerations must be among those which are causing the regulatory agencies to move with care when devising new rules on this subject. These considerations must also be a reason why the proposed new rules appear to be moving in the direction of modifying the computation of the NBBO rather than imposing additional duties of inquiry upon broker/dealers.

Giving the non-moving party the benefit of the doubt, as is required under summary judgment standards, I will assume, arguendo, that the missing data would reveal some damage in a sufficient number of the transactions to surmount the standing challenge. Such "damages," of course, assume the validity of plaintiffs' substantive claims.

E.—DISCUSSION

Standard For Summary Judgment

A court must grant summary judgment if the moving party establishes that "there is no genuine issue as to any material fact and that . . . [it] is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). Once the moving party has carried its burden under Rule 56(c), "its opponent must do more than simply show that there is some metaphysical doubt as to the material facts in question." *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986), *rev'g* 723 F.2d 238 (3d Cir. 1983). The opposing party must set forth specific facts showing a genuine issue for trial, and may not rest upon the mere allegations or denials of its pleadings.

See Celotex Corp. v. Catrett, 477 U.S. 317, 324 (1986); *First National Bank v. Cities Service Co.*, 391 U.S. 253, 289, *reh'g denied*, 393 U.S. 901 (1968); *Sound Ship Bldg. Corp. v. Bethlehem Steel Co.*, 533 F.2d 96, 99 (3d Cir.), *cert. denied*, 429 U.S. 860 (1976). In applying Rule 56(c), the Supreme Court has held that:

> By it very terms, this standard provides that the mere existence of *some* alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact.

Anderson v. Liberty Lobby, Inc., 477 U.S. 242, at 247-48 (1986).

A genuine issue for trial is present whenever "the evidence presents a sufficient disagreement to require submission to a jury." *id.* at 251-252. In contrast, whenever "the record taken as a whole could not lead a rational trier of fact to find for the non-moving party, there is no 'genuine issue for trial.'" *Matsushita*, 474 U.S. at 587. In evaluating the record, the court must both weigh the evidence and draw inferences from it "in the light most favorable to the party opposing the motion." *Whitehead v. St. Joe Lead Co., Inc.*, 729 F.2d 238, 251 (3d Cir. 1984) (quoting *Coastal States Gas Corp. v. Department of Energy*, 644 F.2d 969, 979 (3d Cir. 1981)); *Wahl v. Rexnord, Inc.*, 624 F.2d 1169, 1181 (3d Cir. 1980).

A material fact for each party is one which assists in "establish[ing] the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp.*, 477 U.S. at 321. Although it has been advised that "summary judgment should be used sparingly in complex . . . securities litigation where motive and intent play lead roles and the proof is largely in the hands of the defendants," *Allen Organ Co. v. North American Rockwell Corp.*, 363 F.Supp.

1117, 1124 (E.D. Pa. 1973), if a party fails to establish an essential element upon which it will bear the burden at trial "there can be 'no genuine issue as to any material fact,' since a complete failure of proof concerning an essential element of the non-moving party's case necessarily renders all other facts immaterial." *Celotex Corp.*, 477 U.S. at 321.

Fraud under Section 10(b) and Rule 10b-5

In fulfillment of the Congressional purpose "to substitute a philosophy of full disclosure for the philosophy of caveat emptor . . ." *SEC v. Capital Gains*, 375 U.S. 180, 186 (1963), and pursuant to the authority granted it in Section 10 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(a), the Securities and Exchange Commission has defined fraudulent use of "manipulative and deceptive devices" in the context of the securities industry:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

The parallel to common law fraud is not coincidental: "The federal securities statutes were modeled after the common law actions of fraud and deceit." *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987). In order to prevail on a section 10b-5 claim, a plaintiff must show that:

> 1 a security was sold or purchased accompanied by a misrepresentation or omission of a material fact
>
> 2 defendant acted with scienter
>
> 3 the plaintiff justifiably relied on such misrepresentation in connection with the purchase or sale of a security; and
>
> 4 the plaintiff suffered damage as a result of the misrepresentation or omission.

Sowell v. Butcher & Singer, Inc., 926 F.2d 289, 296 (3rd Cir. 1991). Failure to disclose a material fact is a misrepresentation. *Chiarella v. United States*, 445 U.S. 222, 229 (1979); *Rochez Bros., Inc. v. Rhoades.*, 491 F.2d 402, 407-8 (3d Cir. 1974). Where a reasonable man would attach importance to facts in determining his choice of action in the transaction in question, the facts are material. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.) *cert. denied* 382 U.S. 811 (1965). Scienter is a necessary element in actions brought under Section 10 and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) ("The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."). Conduct that is an "extreme departure from the standards of ordinary care," *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987), may be sufficiently reckless to also form scienter. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977); *McLean v. Alexander*, 599 F.2d 1190, 1197 n.12 (3d Cir. 1979).

Misrepresentation

A broker/dealer owes a fiduciary duty to a retail customer. "[T]he duties of a securities broker are, if anything, more stringent than those imposed by general agency law. All that is necessary [to show fraud based on those duties] is to hold defendant to standards that would govern an agent for the sale of potatoes." *Opper*, 250 F.Supp. at 676; *In re Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911, 915 (1968).

The fiduciary duty is fundamental to the broker/client relationship:

> [W]hen one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses.

L.Loss, *The SEC and the Broker-Dealer*, 1 Vand. L. Rev. 516, 522 (1948). Although it might grow out of broker/dealers' role as agent, the duty does not disappear when the role of principal is assumed. "A broker-dealer's determination to execute an order as principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'" *E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887, Fed. Sec. L. Rep. (CCH) ¶ 84,303, 89,326, 89,328 (July 6, 1988) (*quoting Opper*, 250 F. Supp. at 675).

> The fiduciary duty gives rise to a duty to disclose information in the sole possession of the agent in various circumstances.

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure . . . [S]uch liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.

Chiarella, 445 U.S. at 230. "In circumstances where a broker-dealer's interests conflict with those of the customer . . . [the broker must] disclose all material information to enable the customer to make an informed decision regarding whether to complete the transaction." *Market 2000*, Study V at *2.

No express representation is alleged to have been made to any of the plaintiffs in the present case, but defendants concede that "by holding themselves out as professionals, brokers make an implicit representation to the public that they [will] charge customers 'fair' prices. . ." Defendants' Memorandum In Support of Motion to Dismiss at 31. The crux of the dispute represented by this litigation is disagreement over the meaning of the term "fair" in this context. Plaintiffs allege that defendants' implied representation of fair dealing, upon which they relied, included an obligation, pursuant to the fiduciary nature of the relationship between them, to disclose the material fact that defendants intended to execute plaintiffs' orders at the NBBO rather than at superior available prices in order to satisfy their duty of best execution. Amended Complaint §§ 31-32. The use of various manipulative devices to secretly accrue profits for their own accounts, according to plaintiffs, amounted to a further breach of the duty to disclose and thus a further fraud. Amended Complaint §§ 33-38. Defendants, on the other hand, maintain that "fair" simply means execution at prices no worse than the

current NBBO and that such transaction is equivalent to best execution.

This requires a review of the duty of best execution. Neither party disputes that "fairness" includes a duty of best execution, but the term itself eludes definition: despite its central nature, it inhabits the texts of securities law without revealing its source. "[T]he Commission has not promulgated a separate best execution rule or explicitly defined best execution . . ." *Market 2000,* Study V at *5-6. While Congress, in establishing the NASDAQ, attempted to assure "the practicability of brokers executing investors' orders in the best market," 15 U.S.C. § 78k-1(a)(1)(C)(iv), the duty is ultimately founded in common law:

> A broker-dealer's duty to seek to obtain the best execution of customer orders derives from the common law agency of loyalty, which obligates an agent to act exclusively in the principal's best interest . . . [the agent] is under a duty to exercise reasonable care to obtain the most advantageous terms for the customer.

Market 2000, Study V at *2 *quoting* Restatement 2d of Agency §§ 387 and 424 (1958).

This common law has spawned various interpretative rules when applied to the various securities markets. *See, e.g.,* American Stock Exchange Rule 156(a), 2 Amex Guide (CCH) P 9296,. and New York Stock Exchange Rule 123A.41, 2 NYSE Guide (CCH) P 2123A (requiring members handling market orders to exercise diligence to execute orders at the best prices available). The corresponding NASD rule, cited by defendants, however, exemplifies the imprecision of these rules and the difficulty of using them to clarify the precise meaning of best execution with respect to exclusive use of the NBBO. The NASD rule reads:

> In any transaction for or with a customer, a member . . . shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and

> buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

NASD Rules of Fair Practice, NASD Manual (CCH), Art. III, Sect. 1, ¶ 2151.03. Since a broker/dealer may transact in the same security with a market maker on any one of a number of execution systems, some of which yield different prices, guidance limited to a requirement to determine which market maker is giving the best price when market makers themselves are offering different prices on different systems, can hardly be called helpful.

To add to the difficulty, "best execution" does not necessarily mean "best price." Other factors, such as reliability and speed, have to be considered.

> [B]rokers have not been held . . . to an absolute requirement of achieving the most favorable price on each order[.] [W]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible given all the facts and circumstances. These factors include, among other things, the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the costs and difficulty associated with achieving an execution in a particular market center.

Second Report on Bank Securities Activities: Comparative Regulatory Framework Regarding Brokerage-Type Services 97-98, n.233 (Feb. 3, 1977), *as reprinted in* H.R. Rep. No. 145, 95th Cong., 1st Sess. 2333. It may well be that in any given transaction inquiry of all relevant markets and pending orders might produce a price superior to the NBBO price, but it may not constitute best execution in that transaction because of delay and it may

not constitute best execution generally because were the practice followed in all transactions the interests of all customers in an inexpensive and efficient market might be impaired.

As noted above, none of the sources cited by the parties in support of their respective interpretations of the prevailing standard for the duty of best execution reveals a rule, regulation or interpretation of a regulation which directly addresses the question of whether exclusive reference to the NBBO satisfies that duty. Defendants' narrow interpretation of such terms as "interdealer market" and "best current displayed bid or offer" affords them the opportunity to infer support from sources that do not in fact limit broker/dealers' duty to an obligation to refer only to the interdealer market or quotation display represented by the NASDAQ system. Plaintiffs, on the other hand, offer only broad statements concerning the duty of broker/dealers to obtain best execution that make no mention of the NBBO.

Attempts to rely on industry custom to clarify the prevailing standard for duty of best execution during the class period are similarly of no avail. The affidavits supplied by the parties on market practices predictably contradict each other in conclusory terms that rely solely on the authority of their authors. Declarations of T. Grant Callery, David S. Ruder, Richard Y. Roberts and Junius W. Peake. On balance they provide little guidance. The affidavit of a former OTC trader who attested to his regular use of sources other than the NBBO also failed to shed any light on industry custom during the class period because it described only conduct that preceded the class period. Declaration of Paul M. Lacy, ¶ 2.

Thus it is an undisputed fact that highly qualified, totally responsible participants in the securities market have differing opinions about the best way to execute OTC orders. The regulatory agencies which are experts

in the field are seeking the best approach which will serve the immediate interests of customers and the long-term interests of customers and other market participants in an effective securities market.

Moreover, it is unclear that demonstrating industry custom would be determinative: SEC and judicial rulings concerning failure to exercise reasonable diligence to obtain best execution or to provide sufficient disclosure in the absence of obtaining best execution have been limited to cases in which there have been express representations contrary to existing regulations or SEC interpretations thereof. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (broker-dealer's license revoked as a result of willful violations of Securities Act of 1934); *Opper* (broker made explicit representations that he was attempting to execute plaintiff's orders when in fact he was trading on his own behalf in the same security); *Barnett v. United States*, 319 F.2d 340 (8th Cir. 1963) (Violation of securities antifraud provisions found where firm, after expressly accepting customer's order to sell, traded on its own behalf in same security without executing customer's order).[11]

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[11] Plaintiffs cite *Chassins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) for the proposition that even if it were industry custom to execute exclusively at the NBBO, defendants could not use such industry wide practice as a shield against an allegation of misrepresentation because "[E]ven where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation." Two factors differentiate this case from the present one: 1) The court in *Chassins* was clear to limit its decision to "the particular circumstances proved in this case." *Chassins*, 438 F.2d at 1172. "We do not attempt to address ourselves to the question of [the relevant industry policy]." *Id.* 2) The circumstances surrounding the parties' interaction in *Chassins* were established in great detail and the omission, a failure to inform the customer of the broker/dealer's market maker status, was placed in this context of express representations. Plaintiffs'

Plaintiffs here have made no allegations that any express representation was made in any of the subject transactions. No special circumstances are shown. Rule 10b-5 makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, *in the light of the circumstances under which they were made,* not misleading." 17 C.F.R. § 240.10b-5(b) (emphasis added). "[W]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible *given all the facts and circumstances.*" *Payment For Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, 84,536 at 84,541 (emphasis added). Even if plaintiffs, as class representatives, were to show some special circumstances, pursuit of the class action would be prohibitively unwieldy, requiring investigation into each and every covered transaction to determine what special circumstances, if any, were sufficiently similar to those alleged in the complaint to warrant inclusion in the class.

Furthermore, the implied representations, a promise of "fair dealing," specifically, to obtain best execution, are built on shifting sands: no one is sure quite what best execution means in all circumstances. It may be that best execution was not in fact satisfied in th subject transactions by exclusive reference to the NBBO, but it would be highly imprudent to hold defendants liable for making a material omission of fact by means of an implied representation based on a ill-defined duty that the relevant regulatory agency is only now struggling to clarify for an industry that is constantly undergoing technological change.

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allegations here are premised on solely on the general nature of the relationship between the parties and make no effort to particularize any misrepresentations.

Scienter

Even if defendants, in holding themselves out as broker/dealers who would charge their customers "fair" prices, made an implied representation that "omitted" a material fact, that is, that there might be prices better than the NBBO available, a jury could not reasonably find that there was an intent to deceive or an "extreme departure from the standards of ordinary care" sufficient to constitute the requisite scienter for a claim of fraud. Knowledge of omitted facts on its own does not establish scienter. *SEC v. Southwest Coal & Energy Co.*, 624 F.2d 1312, 1321 n.17 (5th 1980) ("[K]nowledge of the fraud, and not merely the undisclosed facts, is indispensable . . ." to proving securities fraud. *Quoting Hirsh v. duPont*, 553 F.2d 750, 759 (2d Cir. 1977)). There must be an intent to deceive, *Ernst*, 425 U.S. at 197 and 199; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J.) "[I]mposition of liability for damages under Rule 10b-5(2), absent a *scienter* requirement . . . would [] go beyond the authority vested in the Commission by § 10(b) to act against 'any manipulative or deceptive device or contrivance' and be so inconsistent with the general structure of the statutes as to be impermissible . . ."); or a reckless omission of material facts, *Coleco Industries, Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977) (per curiam), *cert. denied*, 439 U.S. 830 (1978) (scienter element in a § 10(b) case requires "a conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception."); *McLean* at 1197 n.12; *see also Sundstrand Corp.*, 553 F.2d at 1044-45; *Shivangi*, 825 F.2d at 889; *and Franke v. Midwestern Oklahoma Development Authority*, 428 F.Supp. 719, 725 (W.D. Okl. 1976) ("[R]eckless conduct may be defined as a highly unreasonable omission, involving . . . an extreme departure from the standards of ordinary care . . .").

It is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret. The issue before the regulatory agencies is whether the practice should be modified and, if so, how.

The absence of contemporaneous SEC or NASD guidance on the validity of exclusive reference to the NBBO makes formation of an intent to deceive as to the sufficiency of such conduct a contradiction of terms. Broker/dealers are obliged by statute to adhere to SEC and NASD regulations. Where there is no regulation in place, it might reasonably be argued that there could be commission of an act which later, after promulgation of relevant rules, could be said to have been unfair, but it cannot be maintained that an intent to deceive as to a prevailing standard could exist when the standard was, at the time, as yet undetermined by the relevant authorities. *Christidis v. First Pennsylvania Mortg. Trust*, 717 F.2d 96, 100 (3d Cir. 1983) (dismissal for lack of scienter in securities fraud action brought under Section 10(b) was based on Rule 9(b) defect of failure to show that "defendants knowingly departed from reasonable [industry] practices."). The alternative contention that there might be liability for reckless departure from an ordinary standard of care when the current standard of care was at best ambiguous is similarly untenable: one cannot recklessly disregard that which is not discernible. *See Platsis v. E.F. Hutton & Co.*, 946 F.2d 38, 41 ("Since very few brokers disclosed [the alleged material fact] at the time the[] events took place and there was no established regulatory duty to disclose these items, an intent to deceive or an 'extreme departure from the standards of ordinary care' could not be established merely by the omission of this information in the absence of special circumstances.")

Scope of Judicial Scrutiny

In a modern market that involves both rapid evolution of technology and large-scale expansion of the use of that technology, a state of constant and sometimes radical change may, in one sense, represent the "status quo." For the past twenty years the world of the stock exchange floor, the ticker tape and face-to-face trading, while still an active part of the securities business, has steadily been giving way to the world of quotation display screens and on-line transactions. Much of the trading that only recently took place on a handful of national exchanges now occurs on large, decentralized networks of electronically linked offices throughout the world. The constant challenge presented by technological improvements, new investment vehicles and the rise of new trading methods in this evolving environment makes the need for a governmental agency dedicated exclusively to monitoring and regulating its smooth functioning all the more evident.

Congress has established the manner in which rules governing the OTC market should be devised. NASDAQ is an indirect subsidiary of the NASD. The NASD is a self-regulatory organization that is empowered by statute to operate the NASDAQ system and to promulgate and enforce rules of conduct for all firms that act as securities brokers or dealers. Under the Securities Exchange Act of 1934, all brokers and dealers must be NASD members, and are subject to the rules and standards imposed by the NASD. 15 U.S.C. § 78o(b)(8). The SEC must review and approve any NASD rule before the rule becomes effective. 15 U.S.C. § 78s. The NASD and SEC are the agencies to which Congress has assigned these comprehensive and delicate tasks, which require a depth of expertise and familiarity with the markets.

"The SEC [was] invested [by Congress] with broad discretionary powers equal to the complex and changing nature of the problems arising in the securities industry."

Gordon v. New York Stock Exchange, Inc., 498 F.2d 1303, 1306 (2d Cir. 1974), aff'd 422 US 659 (1975) (cf. H.R. Rep. No. 1383 at 6-7, 73d Cong, 2d Sess (1934)). It is inappropriate for courts to interfere with that mandate except under extraordinary circumstances. "[T]he expertise of [the agency] is far greater than that possessed by the courts . . . at least with respect to the economic complexities and technicalities inherent in [the regulated industry]." *Movers' & Warehousemen's Ass'n. of Amer. v. United States*, 303 F.Supp. 563 (D.N.J. 1969). The Supreme Court has said "[The function of an agency] is not only to appraise the facts and to draw inferences from them but also to bring to bear upon the problem an expert judgment and to determine from its analysis of the total situation on which side of the controversy the public interest lies." *United States et al. v. Detroit & Cleveland Navigation Co. et al.*, 326 U.S. 236, 241 (1945).

The issues which plaintiffs raise have been and are being specifically addressed by the SEC and the NASD. The rules recently proposed by the SEC contemplate the inclusion of any quotes posted on any alternative sources in the required best bid/ask quotation that broker/dealers are required to post on NASDAQ Levels 2 and 3.

> The proposed amendments . . . are intended to improve the quality and expand the scope of published quotation information from OTC market makers and specialists by requiring them to reflect in their public quotes the bid and offer prices (*e.g.*, priced orders) they disseminate through electronic communications networks that provide the ability to execute against these priced orders.

Order Execution Obligations at 21-22. Thus the NBBO, the composite best bid and offer as derived from all market makers posted quotes, would, if the proposals are adopted, reflect not just the best prices available on the NASDAQ

Level 2, but the best prices available from *all* sources, including SelectNet and Instinet. In choosing to remedy the problem of the "splintering" of quotaton information, whereby "OTC market makers and specialists publish[] different proposed trading prices in different quotation systems, some with limited access," *id.* at 20, by "expanding" the NBBO rather than clarifying the nature of the broker/dealers' obligation to maintain parity with the NBBO, the SEC has considered all the relevant commercial, technical, and legal factors, applied its expertise and devised a regulatory scheme that best protects the public interest. NAqcess, the proposed replacement for the SOES system that would allow interaction between retail limit orders and market orders is a similarly carefully considered solution, designed to accommodate the various and sometimes conflicting interests of professional traders, their customers and the general public.

It should be noted that the solutions proposed by the regulatory agencies eliminate difficulties that would be inherent in the procedures which plaintiffs contend defendants should have followed. Broker/dealers could in the usual situation still refer to a single quotation system, the NBBO, modified to reflect additional data. They would not have to delay execution of orders by referring to multiple quotation systems, some of which might be available to all broker/dealers. It should also be noted that the proposed regulations are prospective only.

Thus, without commenting on the sufficiency of exclusive reference to the NBBO to satisfy the duty of best execution, the SEC has, in its wisdom, determined that it is in the interest of maintaining fair and orderly markets and assuring "the practicability of brokers executing investors' orders in the best market," 15 U.S.C. § 78k-1(a)(1)(C)(iv), that the NBBO should reflect the full range of interdealer quotes and that some retail limit and market orders should be crossed. Such a pronouncement indicates

that the appropriate regulatory agency, in its capacity as the governmental body charged with maintaining expertise on the current condition of the securities markets and overseeing their fair and efficient operation, has studied the problem of ensuring best execution of retail customers' orders, has taken into consideration the state of the technology and the proliferation of alternative sources of liquidity, has weighed the competing interests of cost of compliance and public confidence and has fashioned a solution that takes into account all the relevant factors.

These regulatory developments confirm that defendants cannot have misrepresented material facts by following existing practices and that defendants cannot have acted with scienter when only now the regulatory agencies are exploring and adopting regulations designed to meet a continually evolving market.

It would not be appropriate for a court or a jury to inject itself into this carefully considered determination. The court has not been asked to prospectively enjoin the defendants, to review administrative regulations for arbitrary and capricious use of regulatory discretion or to compel the SEC to fulfill its statutory mandate. Plaintiffs are effectively asking the court to retroactively second-guess the SEC. While the comprehensive scheme devised by Congress to regulate the securities industry may itself be ripe for reform [12], the judiciary should not be used as a method to bypass that scheme. In light of all the fore-

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[12] In response to criticism that the NASD has failed to keep pace with the growth and evolution of the NASDAQ market, the NASD recently accepted the recommendation of an advisory committee, chaired by former Senator Warren B. Rudman, to implement a major structural reorganization, breaking the NASD into three independent bodies, in charge of policymaking, regulation of broker/dealers and operation of NASDAQ respectively with each entity governed by mixed boards of industry and non-industry representatives. *Executive Summary of the Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors* at 21-22.

going, summary judgment must be granted in favor of defendants on plaintiffs' federal claims.

State Law Claims

Count II of the Amended Complaint alleges breach of fiduciary duty under state law. Count III alleges unjust enrichment under state law. Insufficiency of a claim under federal securities laws does not necessarily preclude liability under state common law, *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 479 (1977); *Gochnauer,* 810 F.2d at 1050. However, district courts may decline to exercise supplemental jurisdiction over a pendant state claim "if the district court has dismissed all claims over which it has original jurisdiction." 28 U.S.C. § 1367(c)(3); *United Mine Workers v. Gibbs,* 383 U.S. 715, 726 (1966) ("If the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well"); *Tully v. Mott Supermarkets, Inc.,* 540 F.2d 187, 196 (3d Cir. 1976) (Dismissal of pendant state law claims in a securities fraud action brought under Section 10(b): "If it appears that the federal claim is subject to dismissal . . . or could be disposed of on a motion for summary judgment under F.R.Civ.P. 56, then the court should ordinarily refrain from exercising jurisdiction . . ."). Accordingly, plaintiffs' state law claims will be dismissed without prejudice.

CONCLUSION

For the reasons stated above, the motion of defendants for summary judgment on plaintiffs' federal claims is granted. Plaintiffs' state law claims will be dismissed without prejudice.

An appropriate order follows.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

Date: December 13, 1995.

[Filed Dec. 15, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*
SECURITIES LITIGATION

ORDER

These matters having been opened to the Court by defendants PaineWebber, Inc., Merrill Lynch Pierce Fenner & Smith, Inc., and Dean Witter Reynolds, Inc., and notice having been given to all parties, in consideration of the papers submitted, for good cause shown, and for the reasons set forth in the Court's opinion of even date,

IT IS, on this 13th day of December, 1995,

ORDERED as follows:

1. Defendants' motion for summary judgment on plaintiffs' federal claims is granted.

2. Count I of the Amended and Consolidated Class Action Complaint is dismissed with prejudice.

3. Counts II and III of the Amended and Consolidated Class Action Complaint are dismissed without prejudice.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

APPENDIX D

Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, No. 94-5343 (DRD) (Sept. 14, 1995)

[Filed Sep. 14, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*,
SECURITIES LITIGATION

OPINION

Debevoise, Senior District Judge.

Defendants move to dismiss plaintiffs' amended complaint. For the reasons which follow, the motion to dismiss will be converted into a motion for summary judgment.

BACKGROUND

This is a class action against securities dealers Painewebber, Inc. ("Painewebber"), Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), and Dean Witter Reynolds, Inc. ("Dean Witter"). The plaintiffs claim that those defendants committed unlawful and fraudulent acts against them in violation of Section 10(b) of the Federal Securities Exchange Act of 1934 ("Section 10(b)"), Rule 10b-5 promulgated thereunder ("Rule 10b-5"), and applicable state common law. This alleged violation occurred when the defendants purportedly acted to benefit themselves at the expense and to the detriment of plaintiffs and the class by fraudulently and/or recklessly fail-

ing to fulfill their duty to execute market orders at the best reasonably available prices.

The plaintiffs are customers of the defendants. Plaintiff MLPF&S Cust. FPO, Bruce Zakheim IRA FBO Bruce Zakheim, is a New Jersey resident. During the Class Period, Zakheim was a retail customer of Defendant Merrill Lynch and placed market orders for over-the-counter ("OTC") stocks through a Merrill Lynch retail stock broker at a Merrill Lynch office located in Marlton, New Jersey. For example, on June 7, 1994, a market order was placed with Merrill Lynch to buy 120 shares of U.S. Healthcare stock. Merrill Lynch allegedly did not execute that order at the best available price, thereby damaging Zakheim.

Plaintiff Jeffrey Phillip Kravitz is a California resident. During the Class Period, Kravitz was a retail customer of defendant Dean Witter and place market orders for OTC stocks through a Dean Witter retail stock broker at a Dean Witter office in Malibu, California. For example, on February 11, 1994, a market order was placed with Dean Witter to buy 100 shares of Simpson Industries stock and on September 21, 1994, a market order was placed with Dean Witter to buy 100 shares of Safety Components stock. Dean Witter allegedly did not execute either one of these orders at the best available stock price, thereby damaging Kravitz on both transactions.

Plaintiff Gloria Binder is a New York resident. During the Class Period Binder was a retail customer of defendant Painewebber and placed market orders for OTC stocks through a Painewebber retail stock broker at a Painewebber office in Melville, New York. For example, on April 21, 1994, a market order was place with Painewebber to buy 1,000 shares of Optical Radiation stock. Painewebber allegedly did not execute the order at the best available price, thereby damaging Binder.

The defendants in this case are members of the National Association of Securities Dealers ("NASD"), a trade asso-

ciation of securities brokers and dealers. Under the Securities Exchange Act of 1934, all brokers and dealers must be NASD members, and are subject to the rules and standards imposed by the NASD. The Securities and Exchange Commission ("SEC") must review and approve any NASD rule before the rule becomes effective.

The NASD has set up an automated quotation system called NASDAQ, which is the fastest growing stock market in the United States. NASDAQ stocks are traded over-the-counter, by way of computer and telephone communication between separated independent securities dealers. As an interdealer market, NASDAQ relies on competition among approximately 500 market-making firms. Unlike auction markets such as the New York Stock Exchange, NASDAQ does not depend on centralizing order flow in one location where "matching" orders from public customers will be executed against each other. NASDAQ relies on competition among many dealers risking their own capital, rather than a single regulated monopolist or stock exchange "specialist" firm, to assure liquidity.

Upon receiving an order to buy stock, defendants will buy securities at a "bid" price and sell them to customers at a higher "ask" or "offer" price, making a "two-sided" market. Market makers therefore make a part of their compensation from the "spread" between the bid and the ask price.

All market makers have access to NASDAQ workstations that include a "Level 2" screen showing the bid and ask prices of other market makers. For any given NASDAQ stock, the highest bid price and the lowest ask or offer price among all dealers making a market in the stock is sometimes referred to as the "NBBO"—the national best bid and offer. A broker buying stock at the NBBO is buying stock for a customer at the best price quoted by any market maker on the NASDAQ system.

The stock transactions which plaintiffs allege were in violation of federal securities laws and state common law

were executed at the NBBO. It is plaintiffs' contention that the lowest price—and therefore the best price—was not at the NBBO. Rather, plaintiffs assert that the defendants could have offered them a lower price based on alternative price quotation systems to which defendants have access. Those systems, which defendants use to execute trades on their own accounts, provide execution prices from other broker-dealers and institutional customers. The systems include SelectNet and Instinet.

SelectNet is a communications feature that is currently available to all NASDAQ market makers through their computer workstations. It is essentially a substitute for telephone communication. Therefore, it is not a continuous two-sided market, but rather a proposal from one dealer to another to engage in a specific transaction in a specific security at a specific price.

Instinet is private corporation owned and operated by Reuters Holdings PLC. It is a stock brokerage service by which institutions can electronically display prospective transactions by way of computer hook-ups to firms that pay a subscription fee to Instinet.

In the Amended Complaint, the plaintiffs allege that defendants did not execute the plaintiffs' stock orders at the best available prices, that the plaintiffs' were caused injuries by not receiving the best available prices, and that the defendants profited from the failure to sell or buy at the best available price through one or more of six deceitful and fraudulent devices, without knowledge or consent of the plaintiffs. The defendants allegedly used the following devices to generate undisclosed profits for themselves at the expense and to the detriment of the plaintiffs:

* acquiring stock for their own inventories from retail customers (who placed market orders to sell stock) at prices lower than otherwise available market prices, and selling stock out of inventory to

retail customers (who placed market orders to buy stock) at higher than otherwise available market prices;

* receiving and executing market orders to sell and to buy equal amounts of shares in the same stock at the NBBO quotes, thus appropriating the difference between the NBBO quotes to themselves while incurring no risk, instead of crossing the orders and executing both sides between the spread;

* executing orders for shares of particular stocks at the NBBO quotes even where superior prices were available through, for example, Instinet and Select-Net, that would result in better execution prices and result in a smaller overall spread (reflecting less risk) between the lowest market price available to a seller of such stock and the highest market price available to a buyer of such stock;

* executing orders to either sell or buy shares of particular stocks at the NBBO despite having received corresponding "limit" orders (orders to buy or sell a particular stock at a specific price or better) from other customers to sell or buy shares of that same stock at prices superior to the NBBO;

* executing market orders to either sell or buy shares of particular stocks at the NBBO quotes despite better prices being available, and then immediately retrading those same shares at those better prices for defendants' own profits; and

* selling orders to other firms to execute at NBBO quotes, without knowledge or consent of the customers placing the orders, and without regard to the availability of superior execution prices.

DISCUSSION

Defendants move to dismiss the Amended Complaint for failure to state a claim. Defendants make two basic arguments in response to plaintiffs' allegations. First, they assert that their best execution obligation is fulfilled when they execute a trade on behalf of their customers at the NBBO. Second, they contend that there is nothing wrong with the practice of market makers trading on their own accounts at prices that are "superior" to the retail prices available to plaintiffs and other retail investors. Defendants argue that both the SEC and the NASD have approved of both of the above practices.

Plaintiffs dispute defendants' contention that selling OTC stocks to their customers at the NBBO fulfills their best execution obligation. They contend that defendants' use of only the NBBO too narrowly defines the market from which they ascertain the best price for OTC stock. Plaintiffs insist that defendants have a duty to monitor the price they charge their other customers, which include institutional clients and other dealers, to ensure that public retail customers are receiving the best available prices. Plaintiffs additionally dispute the defendants' assertion that the SEC and the NASD have both decided that the use of the NBBO quote fulfills a dealer's duty of best execution.

Although the parties have done a fine job of briefing the issues involved in this case, additional information is necessary to decide whether the plaintiffs' claims have merit. Because there is not enough before the court to resolve the motion to dismiss on the pleadings, the motion will be converted into one for summary judgment.

Certain minimal factual data will be required in order to proceed with the pending motion. Each defendant is requested to supply by way of affidavit and supporting documents information relating to each transaction which

the defendants conducted on behalf of each named plaintiff, including the date of each order, the manner in which it was executed, the NBBO price and the prices of the security involved shown on the SelectNet and Instinet systems. In addition, each party is requested to submit by way of affidavit and pertinent documents information about market practices and regulatory requirements or advisories concerning transactions such as those which are the subject of the complaint.

The parties shall submit these factual materials on or before October 13, 1995. Any party may submit responsive material and shall submit supplemental briefs on or before October 27. The motion for summary judgment will be argued at 9 a.m. on November 13, 1995.

CONCLUSION

For the reasons set forth above, the motion to dismiss is converted into one for summary judgment, and the parties shall appear before this court on November 13 to argue the motion. An appropriate order follows.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

Date: September 13, 1995

[Filed Sep. 14, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*,
SECURITIES LITIGATION

ORDER

This matter having been opened to the court upon motion of defendants' counsel; and the court having considered all papers submitted; and in accordance with the opinion of even date;

IT IS on this 13th day of September 1995

ORDERED as follows:

1. The motion to dismissed shall be converted to one for summary judgment;

2. The parties shall by October 13 submit affidavits and other information specified in the foregoing opinion;

3. The parties may by October 27 submit reply affidavits and documentation and shall submit supplemental briefs; and

4. Argument of the motion for summary judgment shall be held at 9:00 a.m. on November 13, 1995.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

APPENDIX E

Order of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (July 30, 1997)

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-5045

KENNETH E. NEWTON; MLPF&S CUST. BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

v.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PAINEWEBBER INC.; DEAN WITTER REYNOLDS
(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

Present: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, SCIRICA, NYGAARD, ALITO, ROTH, LEWIS, *Circuit Judges*, and MAZZONE, *District Judge* *

---

* Hon. A. David Mazzone, United States District Court for the District of Massachusetts, sitting by designation, as to panel rehearing only.

ORDER

A majority of the judges of this court in regular active service who are not disqualified having voted for rehearing en banc in the above appeal, it is

ORDERED that the Clerk of this Court vacate the opinion filed June 19, 1997 and list the above case for rehearing en banc at the convenience of the court.

By the Court,
/s/ Dolores K. Sloviter
Chief Judge

Dated: July 30, 1997

APPENDIX F

Securities Exchange Act of 1934, § 10(b),
15 U.S.C. § 78j(b)

---

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

APPENDIX G

17 C.F.R. § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Supreme Court, U.S.
FILED
JUN 3 1998
CLERK

(2)

No. 97-1768

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PAINEWEBBER INC., AND DEAN WITTER REYNOLDS INC.

Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER,
AND BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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RESPONDENTS' BRIEF IN OPPOSITION

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28 pp

QUESTION PRESENTED

Whether the Court should review an interlocutory, unanimous en banc court of appeals decision reversing the district court's grant of summary judgment for petitioners where the court of appeals found there were contested issues of material fact about (a) the reasonable availability of better prices that petitioners deliberately failed to provide when executing trades for their customers, and (b) whether petitioners knowingly or recklessly deceived their customers by not disclosing their execution practices or the profits they made for themselves at the expense of their customers.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF AUTHORITIES iii

STATEMENT OF THE CASE 1

1. Background 2
2. Summary Judgment 5
3. The Panel Decision 8
4. The En Banc Decision 8

REASONS FOR DENYING THE WRIT 13

I. REVIEW OF THE THIRD CIRCUIT'S INTERLOCUTORY FACT-BOUND RULING IS UNWARRANTED 15

II. THE THIRD CIRCUIT DECISION IS NOT IN CONFLICT WITH DECISIONS OF THIS COURT OR OTHER CIRCUIT COURTS 17

A. The Purportedly "Conflicting" Decisions About Scienter And Industry Custom Do Not Conflict 17

B. The Third Circuit Ruling Is Consistent With Santa Fe Industries, Inc. v. Green 21

CONCLUSION 23

TABLE OF AUTHORITIES

CASES Page

Banca Cremi, S.A. v. Alex Brown & Sons, Inc.,
132 F.3d 1017 (4th Cir. 1997) 22
Basic Inc. v. Levinson,
485 U.S. 224 (1988) 17
Bateman Eichler, Hill Richards, Inc. v. Berner,
472 U.S 299 (1985) 17
Blue Chip Stamps v. Manor Drug Stores,
421 U.S. 723 (1975) 17
Central Bank of Denver, N.A. v. First Interstate
Bank of Denver, N.A.,
511 U.S. 164 (1994) 16, 17
Ernst & Ernst v. Hochfelder,
425 U.S. 185 (1976) 17, 18
Forkin v. Rooney Pace, Inc.,
804 F.2d 1047 (8th Cir. 1986) 21
Kas v. Fin. Gen. Bankshares, Inc.,
796 F.2d 508 (D.C. Cir. 1986) 22
Lampf, Pleva, Lipkind, Prupis & Petigrow
v. Gilbertson , 501 U.S. 350 (1991) 17
Marine Bank v. Weaver,
455 U.S. 551 (1982) 17
Messer v. E.F. Hutton & Co.,
847 F.2d 673 (11th Cir. 1987) 20
Platsis v. E.F. Hutton & Co.,
946 F.2d 38 (6th Cir. 1991), cert. denied,
503 U.S. 984 (1992) 18, 19
Santa Fe Industries, Inc. v. Green,
430 U.S. 462 (1977) ..... *passim*
Shemtob v. Shearson, Hammill & Co.,
448 F.2d 442 (2d Cir. 1971) 21

Shivangi v. Dean Witter Reynolds, Inc.,
825 F.2d 885 (5th Cir. 1987) 18, 20
United States v. O'Hagan,
__ U.S. __, 117 S. Ct. 2199 (1997) 22
Virginia Military Institute v. United States,
508 U.S. 946 (1993) 16

STATUTE AND RULE

Securities Exchange Act of 1934, Section 10(b),
15 U.S.C.F.R. §78j(b) ..... *passim*

Securities and Exchange Commission, Rule 10(b)-5,
17 C.F.R. §240.10b-5 ..... *passim*

TREATISE

STERN, GRESSMAN, SHAPIRO, SUPREME COURT
PRACTICE 197 (7th ed. 1993) 16

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PAINEWEBBER INC., AND DEAN WITTER REYNOLDS INC.,

Petitioners,

V.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER,
AND BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

RESPONDENTS' BRIEF IN OPPOSITION

STATEMENT OF THE CASE

Respondents brought this case as a class action on behalf of customers of the three petitioner securities broker-dealers. Respondents claim that at least from November 1992 to November 1994 (the "Class Period"), the petitioners fraudulently obtained undisclosed profits by executing the

respondents' market orders to buy and sell NASDAQ stocks at so-called "NBBO" prices rather than at better prices that were reasonably available -- and that the petitioners used when trading for their own accounts.

The Third Circuit en banc voted unanimously (10-0) to reverse the district court's grant of summary judgment for the petitioners, ruling that material issues of fact are in dispute.

The Third Circuit's ruling does not warrant review. This case comes here in an interlocutory posture, was decided correctly, breaks no new ground, and conflicts with no decision of this Court or any other court of appeals.

1. Background. Respondents are investors who placed market orders with petitioners to purchase or sell stocks listed on the electronic system known as the National Association of Securities Dealers Automated Quotation system, or "NASDAQ." Petitioners are broker-dealers; they accept stock orders from the public and also make markets in NASDAQ stocks trading from and for their own accounts. NASDAQ displays quotes offered by market makers for specific stocks. Market makers trade those securities with the public at bid and ask (buy and sell) prices. The bid price is generally lower than the ask price. The market maker is compensated for its commitment of capital and the trading risk it incurs -- i.e., the risk that the market will move against it -- by the spread between bid and ask prices. Pet. App. 43a. The highest bid and lowest ask prices entered by market makers on the NASDAQ system for each stock are called the "NBBO" -- national best bid and offer -- prices. Id. 43a-44a.[1]

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[1]A market maker is also compensated for executing customer orders by charging a markup on top of the execution price (or, in the case of a sale, a markdown). The markup or markdown is earned regardless of the spread.

Respondents' Amended and Consolidated Class Action Complaint (the "Complaint" or "Cplt.") alleges that during the Class Period the petitioners secretly profited at respondents' expense by executing the respondents' market orders at NBBO prices even when better prices were reasonably available to petitioners from sources other than the NBBO, including other electronic trading systems such as Instinet (a private network owned by Reuters Holdings PLC) and SelectNet (a computer exchange service owned by NASDAQ), systems which petitioners used in executing trades for their own accounts. App. 19-43.[2] In particular, the Complaint alleges that the petitioners, without disclosure to their customers:

> bought stock for their own accounts from customers at prices lower than otherwise reasonably available market prices from alternative sources like Instinet, and sold stock from their own accounts to their customers at prices higher than otherwise reasonably available market prices (Cplt. ¶33, Pet. 31-32);
>
> executed co-existing market orders to sell and to buy shares of the same stock at NBBO prices (thereby obtaining the spread between the NBBO prices without incurring any risk), rather than crossing the orders and executing them at a price within the NBBO spread and hence superior to NBBO prices (Cplt. ¶¶34, 35, Pet. 32-34);

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[2]"App." refers to the Appendix To Brief Of Appellants respondents filed in the Third Circuit.

> executed market orders at NBBO prices despite the existence of corresponding limit orders from other customers for shares of the same stock at better prices (Cplt. ¶36, Pet. 34); and
>
> routed customers' market orders, in return for consideration, to other market makers who executed them at the NBBO regardless of the reasonable availability of better prices (Cplt. ¶38, Pet. 35).

See Pet. App. 38a-41a, 84a-85a.[3]

Respondents alleged that petitioners' undisclosed practice of profiting by executing respondents' orders at the NBBO even when petitioners knew better prices were reasonably available violated Section 10(b) of the federal Securities Exchange Act of 1934 and Rule 10b-5 promulgated

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[3]The following example illustrates the kinds of conduct at issue here: If the NBBO for a particular stock was $43 bid and $44 asked, and a customer placed a buy order with one of the petitioners, the petitioner would charge the customer $44 (plus a dealer's markup). A customer placing a sell order would be paid $43 (less a dealer's markdown). The petitioner would keep the $1 per share spread between the bid and ask NBBO quotes (plus the markup and markdown). Respondents allege that the petitioner would have executed the trade at NBBO prices even if it knew there were better execution prices otherwise reasonably available on Instinet or SelectNet for the same stock at $43 1/4 bid and $43 3/4 asked. Cplt. ¶33, App. 31-32.

In this case, by executing the orders at the NBBO prices rather than at the better Instinet or SelectNet prices (the best reasonably available prices), petitioner would take a total spread of $1.00 (the difference between $43.00 and $44.00), instead of the legitimate $0.50 spread between the best reasonably available execution prices on Instinet or SelectNet (reflecting the true risk to the petitioner), and thus extract an undisclosed profit of $0.50, i.e., $0.25 per share from each of its customers at no risk to itself.

thereunder because: (a) it meant that the petitioners knew that their implied representations that respondents' orders would be executed at the best reasonably available price were in fact false; and (b) petitioners fraudulently omitted to disclose all material facts in connection with their execution of respondents' trades. Cplt. ¶¶39-45, App. 35-37.

2. Summary Judgment. Petitioners initially filed a motion to dismiss. App. 45-47. After the motion was briefed and argued, the district court sua sponte converted it into a motion for summary judgment. Pet. App. 86a-88a. The court gave the parties six weeks to submit supplemental briefs and affidavits addressed to the limited areas of petitioners' execution of respondents' market orders and relevant market practices and regulatory requirements. Id. Respondents were given no opportunity to depose petitioners' witnesses or to otherwise engage in document discovery on the summary judgment motion, nor had the district court permitted any discovery prior to that point.

In the district court, the petitioners expressly conceded that they had made an implied representation to the respondents that they would charge them "fair prices" (Pet. App. 67a) and admitted during oral argument that they "had an obligation of best execution to the retail orders that they accept from people like the plaintiffs." Transcript (Sept. 11, 1995) at 4, App. 194.[4] The petitioners contended, however, that their exclusive use of NBBO prices satisfied their duty of best execution in all cases. Pet. App. 49a.

Respondents contested that assertion with contrary declarations from Richard Y. Roberts, a Commissioner of the

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[4]See also Pet. App. 68a (petitioners do not dispute "that fairness includes a duty of best execution.").

Securities and Exchange Commission ("SEC") during the Class Period, Junius W. Peake, a former Vice-Chairman of the National Association of Securities Dealers ("NASD") Board of Governors and a securities industry expert, and Paul M. Lacy, a retired NASDAQ trader with over 32 years of experience in the industry. Pet. App. 51a-53a.

Mr. Roberts declared that a broker-dealer who, during the relevant period, automatically executed a customer order at the NBBO price when better prices were reasonably available on Instinet or SelectNet "failed to fulfill its duty of best execution." Roberts Dec. ¶ 7, App. 777. Mr. Peake agreed, declaring that when prices superior to the NBBO are reasonably available through Instinet or SelectNet, or offsetting market or limit orders, "the failure to execute customer market orders at those superior prices does not fulfill a broker-dealer's duty of best execution." Peake Dec. ¶ 6, App. 758. Mr. Lacy declared that he had always understood the duty of best execution to require a broker-dealer to obtain the best price from all reasonably available sources, including Instinet and offsetting market and limit orders. Lacy Dec. ¶¶ 4,5,8,10, App. 718-721.

Mr. Lacy ended his career with a 17 year term at Drexel Burnham Lambert, where he was a Vice President, Over-the-Counter Securities Trader, responsible at any given time for making markets in over 30 securities. Lacy Dec. ¶ 3, App. 718. In executing market orders for those securities, he consistently checked prices available from sources other than the NBBO, including Instinet. Id. at ¶¶ 4-10, App. 718-21. "At no time did [he] ever automatically execute a customer's retail market order at the NBBO if a better price existed through any other reasonably available alternative price source, including Instinet." Id. at ¶ 10, App. 721.

In granting summary judgment, the district court ruled, as the petitioners had acknowledged, that they owed the respondents a duty of "best execution." Transcript (Sept. 11, 1995) at 4, App. 194. The district court went on to hold, however, that the duty of best execution had "no precise meaning ... with respect to exclusive use of the NBBO." Pet. App. 68a. The court's holding was based on the absence of any SEC or NASD "rule, regulation or interpretation of a regulation which directly addresses the question of whether exclusive reference to the NBBO satisfies that [best execution] duty." Id. at 70a. The court further held that "[a]ttempts to rely on industry custom to clarify the prevailing standard for duty of best execution ... are similarly of no avail. The affidavits supplied by the parties on market practices predictably contradict each other ... ." Id.

The district court's holding that the duty of best execution was unclear led it to conclude that, as a matter of law, the petitioners could not have made any misrepresentations on that subject. Id. at 72a. The court also concluded that, even if the petitioners had made misrepresentations, as a matter of law they did not act with the requisite scienter because there was no SEC or NASD rule expressly referring to the practice of executing market orders solely at NBBO prices. Id. at 74a.

Finally, the court said that judicial consideration of the respondents' claims would not "be appropriate" in light of new order execution rules the SEC proposed after the parties had briefed the petitioners' motion to dismiss. Id. at 78a. The new rules (which were adopted on August 28, 1996) expressly require broker-dealers to execute at "the best prices available from all sources, including SelectNet and Instinet" and to cross certain retail market orders and limit orders. Id. at 77a (emphasis in original). The SEC's adoption of prospective

rules (after the Class Period) persuaded the court that it should defer to the regulators.

3. The Panel Decision. Initially a panel of the court of appeals affirmed. Focusing on scienter, Judge Nygaard and District Judge Mazzone (sitting by designation) held that, because the petitioners had been under no existing regulatory or judicially announced duty to disclose their practices of executing exclusively at NBBO prices, "and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices." Pet. App. 25a. Judge Stapleton dissented. Id. at 28a.

Respondents sought rehearing en banc. The SEC simultaneously sought a modification of the panel opinion because the panel suggested that a practice cannot be actionable under the securities fraud laws "if it is 'pervasive' or 'widely followed' in the securities industry." Request of the SEC, Amicus Curiae, For Modification of Panel Opinion (July 11, 1997) at 3. On the contrary, the SEC urged, "if the evidence shows that the defendant acted with intent to deceive or in reckless disregard of whether persons would be misled, it should not be a defense to a fraud charge that others are engaging in the same illegal practice, even on a widespread basis." Id.

4. The En Banc Decision. The court of appeals granted en banc review and, Judge Nygaard having been persuaded, unanimously reversed the district court's grant of summary judgment.

(a) The court began its analysis by noting the parties' agreement that a broker-dealer impliedly represents to its customer that the customer's market order will be executed in

a manner consistent with the duty of best execution and that a broker-dealer who accepts such an order while intending to breach that duty makes a representation that is material to the purchase or sale.

Pet. App. 5a. The court also ruled that "the duty of best execution requires the defendants to execute the plaintiffs' trades at the best reasonably available price." Id. at 7a (footnote omitted).

The en banc court disagreed, however, with the district court's ruling that the best execution duty was too vaguely defined to be enforceable. Rather, the court held:

> While ascertaining what prices are reasonably available in any particular situation may require a factual inquiry into all of the surrounding circumstances, the existence of a broker-dealer's duty to execute at the best of those prices that are reasonably available is well-established and is not so vague as to be without ascertainable content in the context of a particular trade or trades.

Id. at 7a-8a. In so holding, the court had the full backing of the SEC. In the first of three amicus curiae briefs it filed in the appellate court,[5] the SEC noted that it had "explained and discussed the duty [of best execution] in a variety of contexts and in a number of releases and reports over the years," and that the duty had "long been recognized as enforceable through the antifraud provisions of the federal securities laws." Brief

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[5]The first brief was filed with the panel. The second requested modification of the panel opinion. The third, mentioned below, was filed with the full court after rehearing en banc was granted.

of the SEC, Amicus Curiae (Oct. 1996), at 4-5 (footnotes omitted). The SEC added that

> the determination of whether a broker-dealer has provided best execution depends on the facts and circumstances, including what prices are readily available in a particular situation, and ... such facts and circumstances may change over time. That does not mean, however, that the [best execution] duty is too vague or indefinite to be capable of enforcement under the antifraud provisions.

Id. at 8-9 (footnote omitted).

The court then noted that, after the Class Period, the SEC had issued rules "that altered the definition of the NBBO to include consideration of many of the alternative sources of liquidity that plaintiffs claim should have been consulted during the class period, such as SelectNet and Instinet." Pet. App. 8a (citing Order Executions Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290, 48306-16 (Sept. 12, 1996)). Neither the court nor the SEC believed that its proposal or adoption of the new rules answered the question whether the petitioners had committed fraud during the Class Period. As the SEC told the court, the fact that it "was considering (and has now adopted) rules that prospectively affect a broker-dealers' order handling obligations would not make it appropriate for the court to abstain from deciding whether the defendants committed fraud with respect to that obligation as it existed during the period at issue in this case." Brief of the SEC, Amicus Curiae (Oct. 1996) at 12 n.14.

The court also noted that the duty of best execution "has evolved over time with changes in technology and

transformation of the structure of financial markets" (Pet. App. 8a)(footnote omitted) and that "broker-dealers have long been required to conform [their] order practices with changes in technology and markets" (id. at 8a-9a). This, too, was supported by the SEC, which told the court that whether a broker-dealer has satisfied the best execution duty

> has always depended on the facts and circumstances at the time of the trade, and ... it was understood during the class period that broker-dealers had an obligation to periodically assess whether better execution might reasonably be available away from the Nasdaq system. It is thus impossible to state categorically that execution at the NBBO always satisfied the best execution requirement.

Supplemental Brief of the SEC, Amicus Curiae (Nov. 21, 1997) (erroneously dated Nov. 1996) at 2 (footnote omitted).

(b) Having ruled that the duty of best execution is judicially enforceable in this case, and that broker-dealers are required periodically to assess and modify their practices in light of changing circumstances "if necessary to enable their clients to obtain the best reasonably available prices" (Pet. App. 9a), the court then reviewed the record regarding the reasonable availability to petitioners of prices superior to the NBBO during the Class Period. The court noted that both SelectNet and Instinet were in existence throughout the Class Period, that "the defendants themselves actively traded" for their own

accounts through those services, and that "other respected members of the brokerage community ... have regarded these services as providing reasonably available prices" and have used them "when the prices reported were more favorable to the client than the NBBO price." Id. at 10a.[6]

This record evidence led the court to conclude that whether better prices were reasonably available to the petitioners during the Class Period was a question of material fact in dispute; that a finder of fact might conclude that better than NBBO prices actually were reasonably available; and that the same fact finder might conclude that the petitioners' insistence on using inferior NBBO prices, and their refusal to so advise the respondents, made false their representation to the respondents that they would execute their trades in accordance with the duty of best execution. Id. at 10a-12a.

(c) The court then turned to the issue of scienter. It noted the respondents' evidence that other members of the brokerage community refused to rely exclusively on NBBO prices; that "an SEC study found clear evidence of a two-tiered market during the class period, in which NASDAQ market makers routinely traded at one price with retail clients like the [respondents] and at a better price for themselves through quotation services like SelectNet and Instinet"; and that "the possibility that the duty of best execution might require resort to sources other than the NBBO was being actively debated during the class period" and that the debate resulted, after the

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[6]The court also noted that an SEC study of prices on NASDAQ stocks from April through June 1994 found that "'approximately 85% of the bids and offers displayed by market makers in Instinet and 90% of the bids and offers displayed on SelectNet were at better prices than those posted publicly on NASDAQ.'" Pet. App. 10a. (quotation omitted).

Class Period, "in a [SEC] regulation effectively requiring as much." Id. at 13a.

"All of this would allow," the court concluded, "a reasonable trier of fact to find that the [petitioners'] misrepresentation" about how their execution of the respondents' orders "was at least reckless, if not intentional." Id. To be sure, the petitioners had also adduced evidence from other brokers that "their practice during the class period was the same as that of the defendants," and that evidence could be considered probative on the issue of scienter, but at this point it simply raised a material issue of fact precluding summary judgment. Id. at 13a-14a.

(d) Finally, the court held that the petitioners were not immunized as a matter of law from fraud liability even if their fraudulent practices were widely followed by other brokers (id. at 15a); and that the district court's abstention in deference to SEC expertise was wrong: "The district court was not deprived of this enforcement authority [over the securities laws] just because no court or regulator had previously chosen to exercise such authority with respect to the practice challenged here." Id. at 16a.

REASONS FOR DENYING THE WRIT

This Court normally declines review of interlocutory rulings and nothing about this case warrants an exception from that policy. The petition struggles to articulate a conflict between the decision below and a decision of this Court or another court of appeals, but none exists. Nor is there anything worthy of certiorari in the two principal arguments urged by the petition.

The first of those arguments is that the unanimous decision below allows a finding of liability for practices supposedly sanctioned by regulators and followed by others in the industry. Pet. 15-16. The first prong of that contention is incorrect and the second is unremarkable.

The mantle of regulatory approval never existed. Both the district court and the court of appeals were agreed on that score.[7] The SEC itself told the court of appeals that it is "impossible to state categorically that execution at the NBBO always satisfied the best execution requirements" (Supplemental Brief of the SEC, Amicus Curiae (Nov. 21, 1997) at 2) and that its recent rulemaking regarding broker-dealers' obligations in executing market orders does not mean that the courts should "abstain from deciding whether the defendants committed fraud with respect to that obligation as it existed during the period at issue in this case."[8]

As for industry practice, the court of appeals rightly rejected the bold notion that a thing cannot be fraud if "everyone" does it: as the SEC noted, such a rule would "erroneously legitimize widespread fraudulent conduct charged

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[7]The Third Circuit found:

> [T]here is no statute, rule, regulation or interpretation, by the SEC or by a court, that authoritatively establishes that, for all trades, the NBBO exhausted the category of "reasonably available prices" during the class period.

Pet. App. 15a. Similarly, the district court found "neither Congress, the SEC nor the NASD has issued a definitive statement on point concerning use of the NBBO as satisfaction of the duty of best execution." Pet. App. 48a (footnote omitted).

[8]Brief of the SEC, Amicus Curiae (Oct. 1996) at 14 n.14.

in future cases brought either by the Commission or by private parties."[9]

The petitioners' second principal contention is that review is warranted because the decision below supposedly opens the floodgates to plain breach of duty cases disguised as fraud cases. Pet. 23-27. But the petitioners admit that they made implied representations to the respondents in accepting their market orders and they admit that they owed respondents a duty of best execution. Pet. App. 5a; Transcript (Sept. 11, 1995) at 4, Pet. 194. The Complaint alleges that those representations were false and fraudulent, and that petitioners fraudulently omitted to inform respondents of their order execution practices. Those well-pleaded allegations of deceitful misrepresentations and omissions state a claim under §10(b) and Rule 10b-5 and remove this case entirely from the area marked off by Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

I.
REVIEW OF THE THIRD CIRCUIT'S INTERLOCUTORY FACT-BOUND RULING IS UNWARRANTED

None of the ten active judges of the court of appeals who unanimously decided this case saw in it, at its present juncture, any of the legal issues the petitioners set forth and argue in their petition for certiorari. The en banc Third Circuit unanimously concluded this case presented factual disputes that preclude judgment as a matter of law and remanded the case to the district court for further factual development. In particular, the court found disputed issues of material fact concerning (1)

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[9]Request of the SEC, Amicus Curiae, For Modification Of Panel Opinion (July 11, 1997) at 1.

whether prices superior to the NBBO were reasonably available to petitioners for executing their customers' market orders for NASDAQ stocks (Pet. App. 6a, 10a, 14a n.6), and (2) whether petitioners knowingly or recklessly acted contrary to their implied representations to their customers by not providing these better prices in order secretly to profit themselves (id. at 12a-14a). These rulings rest on the law of summary judgment and not on the law of securities regulation. They plainly do not warrant review by the Court.

Certiorari to a federal court of appeals is not ordinarily granted if the decision below is interlocutory and remands a case for further proceedings. See, e.g., Virginia Military Institute v. United States, 508 U.S. 946, 946 (1993), (Scalia, J., concurring)("We generally await final judgment in the lower courts before exercising our certiorari jurisdiction"). See also Stern, Gressman, Shapiro & Geller, SUPREME COURT PRACTICE 197 (7th ed. 1993)("in the absence of some ... unusual factor, the interlocutory nature of a lower court judgment will result in a denial of certiorari").

Obviously, if petitioners prevail after trial, their arguments will be moot. And a more complete trial record will provide a better framework in which to decide whether the evidence supporting the alleged misrepresentations and scienter is adequate under Section 10(b) and Rule 10b-5.

It is true the Court has, on occasion, granted certiorari to review interlocutory decisions by federal courts of appeals in some securities regulation cases. But the reason is not because interlocutory decisions under the federal securities laws are given special treatment. Rather, in each of the cases petitioners cite, the Court granted certiorari to resolve readily apparent conflicts among circuit courts about pure issues of law. For instance, in Central Bank of Denver, N.A. v. First

Interstate Bank of Denver, N.A., 511 U.S. 164, 170 (1994), the Court "resolve[d] the continuing confusion" over liability of aiders and abettors in civil actions under Rule 10b-5, by holding that the statute contained no basis for such liability. The other cases cited by petitioners presented legal issues that were similarly discrete and that had been directly decided by several courts of appeals with varying results. [10]

Nothing in these cases suggests that interlocutory review is appropriate where, as here, material facts are in dispute.

II.
THE THIRD CIRCUIT DECISION IS NOT IN CONFLICT WITH DECISIONS OF THIS COURT OR OTHER CIRCUIT COURTS

A. The Purportedly "Conflicting" Decisions About Scienter And Industry Custom Do Not Conflict

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[10] See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 354 (1991) (resolving 4-2 circuit split over whether to apply state or federal statute of limitations to private suits brought under Rule 10b-5); Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (certiorari was granted "to resolve the split" over the "standard of materiality applicable to preliminary merger discussions"); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 305 (1985) (certiorari was granted because "[t]he lower courts have divided over the proper scope of the in pari delicto defense in securities litigation"); Marine Bank v. Weaver, 455 U.S. 551, 552 (1982) (certiorari was granted to determine whether certificate of deposit and business agreement are "securities"); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976) (certiorari was granted because of circuit split on the standard for scienter in Section 10(b) cases); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (certiorari was granted to determine whether, in light of the disagreement between the Ninth and other circuits, plaintiffs must have purchased or sold securities to assert a cause of action under Section 10(b)).

Contrary to petitioners' assertions (Pet. 15-18), the Third Circuit expressly followed and relied on the Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), that scienter is a necessary element for liability under Section 10(b). Indeed, the court's ruling recognized that the respondents ultimately bear the burden of persuading the ultimate fact finder that petitioners not only failed to disclose their practice of executing market orders with exclusive reference to the NBBO, and thus misrepresented material facts about their execution of the respondents' trades, but also that the petitioners did so knowingly or with reckless disregard for the truth. See Pet. App. 12a-14a.

The three federal appellate decisions the petitioners describe as conflicting with the en banc ruling of the Third Circuit -- Platsis v. E.F. Hutton & Co., 946 F.2d 38 (6th Cir. 1991), cert. denied, 503 U.S. 984 (1992); Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885 (5th Cir. 1987); and Messer v. E.F. Hutton & Co., 847 F.2d 673 (11th Cir. 1987) -- are not discussed or even cited in the court's unanimous opinion. Not a single Circuit Court Judge believed that the court's reversal of summary judgment conflicted with these decisions.

None of the three cited cases concerned the specific practice being challenged in this case. None was decided without a trial. Nor did any of the three cited decisions hold that "industry practice" precludes a finding of scienter so as to provide an absolute defense to a Section 10(b) fraud case under all circumstances.

Rather, in each of them, industry practice and the absence of any regulation were two of several factors that each court considered in determining whether the defendants had acted with scienter as required by Hochfelder. In contrast, in

this case petitioners argue that, absent regulation of particular conduct, industry practice is dispositive on the issue of scienter. As the court of appeals made clear, affirmance of the district court would result in a rule that "a defendant would be entitled to summary judgment even if it were her regular practice to knowingly violate the duty of best execution, so long as she could identify a sufficient number of other broker-dealers engaged in the same wrongful conduct to be able to argue in good faith that the underlying duty was 'ambiguous.'" Pet. App. at 15a.[11]

The Sixth Circuit decision -- Platsis v. E.F. Hutton & Co. -- concerned a broker-dealer's failure to disclose production credits given to the broker and markups on certain bond sales. The Sixth Circuit reversed, as "clearly erroneous," a judgment against the defendants, noting a number of factors that made the defendants' silence "innocent." Platsis, 946 F.2d at 40-41. The court expressly relied upon findings of fact after plaintiff presented evidence at trial, including findings that "the markups and credits were reasonable," and that the plaintiff had represented himself to the defendant as a "sophisticated

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[11]Petitioners are incorrect in contending (Pet. 21-23) that the court, in refusing to enshrine industry practice, imposed an expansive and unprecedented duty on broker-dealers in executing market orders. Early in its opinion, the court squarely adopted the traditional definition of the duty of best execution -- which petitioners concede they owe their customers (Pet. 4) -- as requiring a broker-dealer "to obtain for its customers the most favorable terms reasonably available under the circumstances." Pet. App. 7a. The court's subsequent references to "maximizing" the customer's gain (Pet. App. 7a, 11a-12a, 13a) did not mean that the court had adopted a new definition or fashioned a new duty. Moreover, the court's refusal to adopt petitioners' argument that industry practice is determinative was correct. As the SEC told the court, such a rule would "erroneously legitimize widespread fraudulent conduct charged in future cases brought either by the Commission or by private parties." Request of the SEC, Amicus Curiae, For Modification of Panel Opinion (July 11, 1997) at 1.

investor" who was "familiar with" the defendant's usual spreads. Id. In this case, there has been no finding that the petitioners' execution practices were reasonable or that they were disclosed or known to respondents or other members of the class. And of course there has been no discovery and no trial.

The Fifth Circuit's decision -- Shivangi v. Dean Witter Reynolds, Inc. -- also turned on a number of factors that supported a district court judgment that plaintiffs had failed to prove scienter at trial. The practices at issue -- which were alleged to result in higher commissions to the brokers for certain transactions -- were not shown to have affected the price charged the plaintiffs[12] or the broker's decision to recommend particular stocks. Id. at 889. The court held that these considerations, along with the absence of any SEC or court determination that the compensation information was material and the absence of proof that other brokers disclosed the information, supported the conclusion that scienter had not been proved. See Id.

The Eleventh Circuit's decision -- Messer v. E.F. Hutton & Co. -- involved the question whether the broker's unauthorized sale of a client's treasury bond investments violated Section 6(o)(1) of the Commodities Exchange Act. See Messer, 847 F.2d at 677. In discussing whether the "straddling" strategy employed by the broker in making the sales was a "good business decision," the Eleventh Circuit relied, in part, on its prevalence as an industry practice to protect an account against extreme losses. Id. at 679. The Eleventh Circuit's conclusion that the defendants did not engage in fraud was not, however, based solely on industry

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[12] In the present case the execution price to the respondents was increased as a result of the challenged practices.

practice but instead on findings that the defendant used the challenged strategy to protect its client from precipitous losses, that the client had been out of town and unreachable, and that there was no conflict of interest on behalf of the broker defendant. See Id..

In sum, neither the Sixth, Fifth, nor Eleventh Circuits in the allegedly conflict-creating decisions dealt with the practices involved in this case, and each was decided after discovery and the presentation of evidence during trial.

B. The Third Circuit Ruling Is Consistent With Santa FeIndustries, Inc. v. Green

In Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), minority shareholders of a corporation facing the buy-out of their shares in a short form merger bypassed their right to challenge the buy-out price by an appraisal action in state court and sued under Section 10(b) and Rule 10b-5. See Id. at 467-68. The question presented was whether "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure" were actionable under Section 10(b) and Rule 10b-5. Id. at 470 (quotation omitted). The Court held that they were not, because Rule 10b-5 only addresses deceptive or manipulative conduct. In Santa Fe, there was no deception because the shareholders "were furnished with all relevant information on which to base their decision." Id. at 474.[13]

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[13] Neither is the Third Circuit's decision inconsistent with the court of appeals rulings to which petitioners' refer. Pet. 20-21. Two of those cases, like Santa Fe, lacked any allegations of nondisclosure or misrepresentation. See Forkin v. Rooney Pace, Inc., 804 F.2d 1047, 1050 (8th Cir. 1986) ("The appellants were accurately informed about the status of the transaction at all relevant times."); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) (failure to state claim based on a negligent

In contrast, respondents allege in this case that the petitioners knowingly acted contrary to their implied representations and deliberately misled their customers by failing to disclose their routine practice of extracting secret profits by executing their customers' market orders at the NBBO without reference to better, otherwise reasonably available prices which petitioners knew existed and used for their own benefit. Petitioners' implied misrepresentations and failure to disclose material facts to respondents and other customers is precisely the kind of deceptive conduct that was absent in Santa Fe but which the Court recognized was otherwise enforceable under Section 10(b). Id. at 475-76 & n.15. See also United States v. O'Hagan, __ U.S. __, 117 S. Ct. 2199, 2209 (1997)("[i]n contrast to the Government's allegations in this case, in Santa Fe Industries, all pertinent facts were disclosed by the persons charged with violating §10(b) and Rule 10b-5 ... therefore, there was no deception through nondisclosure to which liability under those provisions could attach")(citation omitted); Kas v. Fin. Gen. Bankshares, Inc., 796 F.2d 508, 512-13 (D.C. Cir. 1986)(Santa Fe does not preclude a fraud action "based on a material nondisclosure or misrepresentation simply because the undisclosed facts involved might also support a breach of fiduciary duty claim"). Accordingly, it was not error for the court of appeals to refuse to order the complaint dismissed on Santa Fe grounds, and review of that refusal is unnecessary.

The ultimate determination of whether the petitioners are liable under Section 10(b) for deceiving respondents will

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failure to sell out account promptly; no allegation of scienter or intent to defraud). The third case, Banca Cremi, S.A. v. Alex Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997), concerned the issue of reliance, where an agent of the plaintiff testified that the subject of alleged non-disclosure was not a consideration in its decision to invest. Id. at 1037.

turn on facts that are contested in the present record. According to the court of appeals ruling, there can be liability for fraud only following a finding by the trier of fact that not only were execution prices better than the NBBO reasonably available to petitioners, but also that petitioners knew those better prices were available and intentionally withheld that information from their customers to secretly profit themselves. Pet. App. 16a. In short, the issues at this stage are factual and do not warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED, PAINE WEBBER INCORPORATED, AND DEAN WITTER REYNOLDS INC.,

Petitioners,

vs.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, AND BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iii

INTERESTS OF THE *AMICUS CURIAE* 1

INTRODUCTION: THE PRACTICE AT ISSUE AND THE RULINGS BELOW 2

SUMMARY OF ARGUMENT 6

ARGUMENT 8

I. THE THIRD CIRCUIT'S DECISION HAS PROFOUND IMPLICATIONS FOR HUNDREDS OF CIVIL ACTIONS PENDING IN THE FEDERAL COURTS, FOR THE CONTINUED OPERATION OF THE SEC'S ENFORCEMENT PROGRAM, AND FOR THE EVOLUTION OF THE NATION'S SECURITIES MARKETS 8

II. THE DECISION BELOW IS IN ERROR AND THREATENS TO EXPAND DRAMATICALLY THE SCOPE AND BURDEN OF SECURITIES FRAUD LITIGATION IN THE FEDERAL COURTS 11

A. The Third Circuit Erred in Holding that an Alleged Breach of a Fiduciary Duty, Which Was Fully Disclosed to the Public and to Regulators, and Which Involved No Manipulation or Deception, Could Constitute Fraud Under Section 10(b) 12

B. The Third Circuit Erred in Holding that Publicly Disclosed Practices that Were Fully Known to Regulators Could Be Conducted With Scienter 16

TABLE OF CONTENTS – Continued

Page

C. The Third Circuit's Errors Threaten to Expand the Scope and Burden of Securities Fraud Litigation in the Federal Courts Beyond Congressional Intent 18

CONCLUSION 20

TABLE OF AUTHORITIES

Page

CASES

Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985) 9

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 7, 8, 20

Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) 7, 19

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 7, 12, 16, 19

GAF Corp. v. Heyman, 724 F.2d 727 (2d Cir. 1983) 15

Herman & McLean v. Huddleston, 459 U.S. 375 (1983) 7, 16

Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) 16

Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) 19

Musick, Peeler & Garret v. Employers Ins. of Wausau, 508 U.S. 286 (1993) 19

Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) ..... *passim*

Sunstrand Chemical Corp. v. SunChemcial Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) 17, 18

United States v. Matthews, 787 F.2d 38 (2d Cir. 1986) 15

STATUTES, RULES AND REGULATORY MATERIALS

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. 78j(b) ..... *passim*

17 C.F.R. § 240.10b-5 ..... *passim*

TABLE OF AUTHORITIES – Continued

Page

Regulation of Exchanges and Alternative Trading Systems, SEC Rel. No. 34-39884, 63 Fed. Reg. 29,301 (Apr. 29, 1998) 11

Request for Comments, SEC Rel. No. 34-38672, 62 Fed. Reg. 30,485 (June 4, 1997) 11

CONGRESSIONAL MATERIALS

Private Litigation Under the Federal Securities Laws: Hearings Before the Senate Subcomm. on Securities, Comm. on Banking, Hous., and Urban Affairs, 103d Cong., 1st Sess. 111 10

S. Rep. No. 104-98 (1995), *reprinted in* 1995 U.S.C.A.A.N. 679 9

MISCELLANEOUS

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Brief of the United States Securities and Exchange Commission, Amicus Curiae, *In re Silicon Graphics Securities Litigation*, United States Court of Appeals for the Ninth Circuit, No. 97-16240, Nov. 1997 16

James D. Cox, Robert W. Hillman & Donald C. Langevoort, *Securities Regulation: Cases and Materials* (2d ed. 1997) 15

Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments* (Jan. 1994) 2

TABLE OF AUTHORITIES – Continued

Page

Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* (John M. Olin Program in Law & Economics, Stanford Law School, Working Paper No. 140, Feb. 1997) 9

Thomas Lee Hazen, *The Law of Securities Regulation* (1996) 9

Inducements for Order Flow: A Report to the Board of Governors, National Association of Securities Dealers Inc. (July 1991) 4

William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Houston L. Rev. 121, 180 (1997) 16

Denise N. Martin, Vinita M. Juneja, Todd S. Foster & Frederick C. Dunbar, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?* (National Economic Research Associates 1996) 8

NASD Panel: Order Flow Cash Payments Need No Special Rules, Dow Jones News Service, July 23, 1991 4

The NASDAQ Stock Market 1997 Fact Book & Company Directory 2

National Association of Securities Dealers, *1997 Annual Report* 11

Richard Walker & David Levine, *The Limits of Central Bank's Textualist Approach – Attempts to Overdraw the Bank Prove Unsuccessful*, 26 Hofstra L. Rev. 1 (1997) 10

Stanford Law School Securities Class Action Clearinghouse 8

INTERESTS OF THE *AMICUS CURIAE*[1]

The National Venture Capital Association is composed of more than 280 professional venture capital firms which, in the aggregate, invest more than 80 percent of all professional venture capital dollars yearly in the nation's emerging growth companies. In 1997, more than $12 billion in venture capital was invested in more than 2,000 companies. The vast majority of these companies are in the high technology industries, including software, communications, healthcare services, electronics, medical devices and biotechnology. Most of the nation's premier companies in these disciplines have, at one point in their operation, obtained venture capital funding. The investment dollars for venture capital financing come largely from limited partners who represent pension funds, colleges and endowments, corporations, banks, insurance companies and high net worth individuals.

Venture capital investing is focused on young companies which are predominantly dedicated to research and development. A common growth path for these companies is to issue shares in an Initial Public Offering. Those shares are frequently traded on the NASDAQ Stock Market, the market in which the practices giving rise to the instant litigation arose.

Venture capitalists frequently become members of the Boards of Directors of the companies in which they invest, taking on fiduciary obligations to the companies and their shareholders. By adopting an overly broad

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[1] The parties have consented to the filing of this brief. Copies of the letters of consent have been lodged with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than *amicus curiae*, its members, and their counsel made a monetary contribution to the preparation and submission of this brief.

interpretation of the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, the Third Circuit decision in this case threatens to exacerbate the problem of "vexatious litigation" that already plagues companies in high technology industries. *Amicus* has a strong interest in reversal of the Third Circuit's ruling that the alleged breach of the fiduciary duty of "best execution," committed by following practices that were publicly known, could give rise to liability under Section 10(b) and Rule 10b-5.

INTRODUCTION: THE PRACTICE AT ISSUE AND THE RULINGS BELOW

Petitioners are broker-dealers in the NASDAQ Stock Market. The NASDAQ Stock Market is "the major electronic market for 'over-the-counter' securities." Pet. App. 2a. It is, by several measures, the largest equities market in the world.[2]

Broker-dealers are subject to a duty of "best execution" which requires them "to execute the plaintiffs' trades at the best *reasonably* available price." Pet. App. 7a (emphasis supplied). The duty of best execution is a fiduciary obligation, Pet. App. 47a, that is "not codified in any SEC rule."[3] It "predates the federal securities laws, [and] has its roots in the common law agency obligations

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[2] *See, e.g., The NASDAQ Stock Market 1997 Fact Book & Company Directory* 1 (The NASDAQ market "has more listed companies than any other market in the world" and trades "more than half of all equity shares traded in the United States.").

[3] Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments*, 1994 SEC LEXIS 136, at V-2 (Jan. 1994) ("the Commission has not promulgated a separate best execution rule").

of undivided loyalty and reasonable care that an agent owes his principal." Pet. App. 6a.

Price is not, however, the sole determinant of best execution. Customers also want speed, both for its own sake and because taking the time to search among a set of alternative market mechanisms may lead to a worse price, particularly in a rapidly moving market. Therefore, when "determining how to execute a client's order a broker-dealer must take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Pet. App. 7a n.2. The fiduciary duty of best execution is thus fluid and as, "the SEC has recognized on a number of occasions, the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of financial markets." Pet. App. 8a.

During the time period at issue, the NASDAQ Stock Market operated through an electronic quotation system which "tied together the numerous market makers for all over-the-counter securities available on NASDAQ." Pet. App. 3a. The market's central computer continually searched the bids and offers submitted into the system to identify the "highest bid price and lowest ask price currently available." Pet. App. 3a. These prices are called the National Best Bid or Offer, or "NBBO."

It was common practice among broker-dealers during the alleged class period to rely on execution at NBBO as satisfying the duty of best execution. The industry's widespread reliance on this practice was known to the Securities and Exchange Commission and to the industry's self-regulatory organization, the National Association of Securities Dealers ("NASD"). Pet. App. 26a. The

practice was also fully disclosed in public documents that were available to all members of the putative class prior to the beginning of the alleged class period.[4] These documents explain the industry's position that "best execution obligations for small, retail orders are satisfied when those orders are executed at the best displayed bid or offer [*i.e.*, the NBBO] at the time the trade is executed."[5] Press reports also clearly described the industry's position that "small orders executed at the best bid or offer are receiving best execution . . . "[6]

Nothing could be more clear. The allegedly fraudulent practice at the heart of this case was public information. "It [was] no secret." Pet. App. 74a.

In their putative class action, plaintiff-respondents allege that the practice of relying on the NBBO to satisfy a broker-dealer's best execution obligation constituted fraud, practiced with an intent to deceive, in violation of Section 10(b) and Rule 10b-5 thereunder. Plaintiff-respondents assert that prices superior to the NBBO were available from other sources, and that broker-dealers violated their best execution obligations by not searching outside the NBBO for those allegedly superior prices.

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[4] *Inducements for Order Flow: A Report to the Board of Governors, National Association of Securities Dealers Inc.* 3 (July 1991).

[5] *Id.* In the Report's view, reliance on the NBBO constituted effective compliance with the best execution obligation because "customers benefit from receiving low-cost, fast, and assured executions at the quoted best bid or offer, and those benefits may equal or exceed benefits obtained through the potential for receiving an execution inside the quotation spread." *Id.*

[6] *NASD Panel: Order Flow Cash Payments Need No Special Rules*, Dow Jones News Service, July 23, 1991, available in WESTLAW, Allnewsplus database.

The district court converted Petitioners' motion to dismiss to one for summary judgment and granted it. The court observed that " 'best execution' does not necessarily mean 'best price,' " Pet. App. 69a, and that "[i]t is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally, followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret." Pet. App. 74a. The Court further explained that "a jury could not reasonably find that there was an intent to deceive or an 'extreme departure from the standards of ordinary care' sufficient to constitute the requisite scienter for a claim of fraud." Pet. App. 73a.

On appeal, a panel of the Third Circuit affirmed. The court expressly held that "where defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices." Pet. App. 25a. The court explained that "[t]o prevail on summary judgment, one need not show that *every* dealer executes trades at the NBBO price, but merely that enough dealers do so that the duty to supplement the NBBO price is *ambiguous*, and scienter is negated." Pet. App. 26a (emphasis in original). Moreover, the fact that the SEC decided to address the relationship between NBBO practices and best execution obligations through a complex set of order execution regulations which came into effect while the appeal was pending, "indicates strongly, if not conclusively that, the 'duty' . . . to look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period." Pet. App. 27a.

On rehearing *en banc*, the Third Circuit reversed and remanded for trial. The *en banc* court described the

alleged misrepresentation as a violation of "an implied representation made by the defendants . . . that they intended to *maximize* the plaintiffs' economic gain in the transaction." Pet. App. 12a (emphasis supplied). The *en banc* court reasoned, through a self-described "chain of inferences," Pet. App. 13a, that if a firm accepted a market order then it impliedly represented that it would "obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available." Pet. App. 12a. The *en banc* court concluded that the Petitioners "knew that they intended to execute the plaintiffs' orders at NBBO price even if better prices were reasonably available," and that a "reasonable trier of fact could thus find scienter with respect to a material misrepresentation," Pet. App. 16a, where scienter is defined as conduct that is "at least reckless, if not intentional." Pet. App. 13a.

SUMMARY OF ARGUMENT

The Petition for a Writ of Certiori should be granted for two distinct reasons.

First, the *en banc* decision below raises profound questions regarding the scope of conduct that is actionable as fraud under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5, as well as the definition of "scienter" thereunder. These questions have significant implications for the administration of justice and for the operation of the nation's securities markets. Hundreds of class action and individual securities fraud lawsuits alleging billions of dollars of damages are today pending in federal court. The lion's share of these cases raise claims under Section 10(b). If followed, the Third Circuit's ruling could massively expand the scope of liability in these pending civil actions. The decision below also has profound implications for the continued operation of the Securities and Exchange Commission's

enforcement program, and for the conduct of business in the nation's increasingly complex and growing securities markets.

Second, the decision below is in plain error. Contrary to this Court's ruling in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Third Circuit holds that a practice that allegedly constitutes a breach of a fiduciary duty, but that is a matter of public record and is fully known to the SEC and to self-regulatory organizations, could constitute actionable fraud under Section 10(b). If upheld, this decision provides a roadmap for the federalization and securitization of every breach of fiduciary duty claim in connection with every securities transaction. The Third Circuit compounds this error by concluding that publicly disclosed practices that are widely followed in an industry and well known to industry regulators could be conducted with "scienter" – a state of mind "embracing intent to deceive." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *see also Herman & McLean v. Huddleston*, 459 U.S. 375, 382 (1983). It thereby materially expands the definition of scienter far beyond the language of the statute and beyond this Court's established precedent.

Indeed, if the Third Circuit's interpretations of *Santa Fe*, *Hochfelder*, or *Huddleston* are allowed to stand, the courthouse doors will be thrown open to litigation challenging conduct that has not heretofore been considered fraudulent under Section 10(b). The result would be a proliferation of "vexatious litigation" under an implied private right of action which Congress never expressly contemplated and which this Court has consistently sought to contain. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Central Bank v. First Interstate Bank*, 511 U.S. 164, 172-73 (1994).

ARGUMENT

I. THE THIRD CIRCUIT'S DECISION HAS PROFOUND IMPLICATIONS FOR HUNDREDS OF CIVIL ACTIONS PENDING IN THE FEDERAL COURTS, FOR THE CONTINUED OPERATION OF THE SEC'S ENFORCEMENT PROGRAM, AND FOR THE EVOLUTION OF THE NATION'S SECURITIES MARKETS.

Chief Justice Rehnquist describes the civil liability arising under the implied private right of action found in Section 10(b) of the Securities and Exchange act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, thereunder, 17 C.F.R. § 240.10b-5 as "a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). The span of that judicial oak is today truly breathtaking.

Since January 1, 1996, at least 366 issuers have been sued in private federal class action securities fraud proceedings, and the vast majority of these cases are still pending in the federal courts.[7] Between January 1991 and June 1996, approximately $3.9 billion was paid out in settlement awards in federal class action securities fraud litigation.[8] The large majority of these cases, pending and

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[7] *See Stanford Law School Securities Class Action Clearinghouse* (available on the internet at http://securities.stanford.edu). The statistic of 366 issuer defendants speaks as of May 20, 1998. More current data are available at the Stanford Clearinghouse Internet site. *Id.*

[8] Denise N. Martin, Vinita M. Juneja, Todd S. Foster & Frederick C. Dunbar, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions?* at ii (National Economic Research Associates 1996).

settled, allege violations of Section 10(b) and Rule 10b-5.[9] Hundreds of additional individual actions alleging violations of Section 10(b) and of Rule 10b-5 have also been filed in federal court in the last several years.[10] Section 10(b) and Rule 10b-5 are thus the "primary tool for private enforcement of the federal securities laws,"[11] and Congress,[12] this Court,[13] and the

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[9] Recent research indicates that at least 77% of these cases allege a violation of Section 10(b) and Rule 10b-5. *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* 23 (John M. Olin Program in Law & Economics, Stanford Law School, Working Paper No. 140, Feb. 1997) (noting that 23% of complaints analyzed alleged violations of the Securities Act of 1933). The percentage of complaints containing Rule 10b-5 allegations is undoubtedly higher than 77% because complaints that allege a violation of the 1933 Act also commonly allege violations of Rule 10b-5.

[10] According to the Administrative Office of the United States Courts, from June 1995 through June 1997, 5,348 cases involving "Securities, Commodities, and Exchanges" were filed in the federal courts. Administrative Office of the United States Courts, *Statistical Tables for the Federal Judiciary* Tbl. C-2 (Jun. 30, 1997); Administrative Office of the United States Courts, Statistical Tables for the Federal Judiciary Tbl. C-2 (Jun. 30, 1996). To be sure, there is an overlap between the securities class action filing data and the Administrative Office data, and not every case included in the Administrative Office data contains a Rule 10b-5 cause of action, but these data are nonetheless suggestive of the potential magnitude of federal litigation affected by the interpretation of Section 10(b) and Rule 10b-5.

[11] Thomas Lee Hazen, *The Law of Securities Regulation* § 13.2 (1996).

[12] *See, e.g.*, S. Rep. No. 104-98 (1995), *reprinted in* 1995 U.S.C.A.A.N. 679, 683 (noting that securities fraud actions "typically rest upon the so called 'catch-all' fraud provision in Section 10(b) of the 1934 Act and SEC Rule 10b-5").

[13] *See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 309 (1985).

Commission[14] have all emphasized the pivotal role that private securities fraud litigation plays in the proper functioning of our capital markets.

Section 10(b) and Rule 10b-5 are also central to the Securities and Exchange Commission's enforcement program. As the current Director of the Division of Enforcement recently emphasized, "Section 10(b) is the principal weapon used by the Securities and Exchange Commission to combat fraud in the securities markets."[15] The questions raised by the Third Circuit's decision go to the heart of the definition of the right of action under Section 10(b) and Rule 10b-5. They are, accordingly, central to the resolution of a large body of significant litigation currently pending before the court.

The issues raised in this litigation also have implications that reach far beyond the judicial process. Our nation's securities markets are in the midst of a rapid and profound technological change. "Alternative trading systems" are emerging in a variety of electronic forms, over the internet and elsewhere, and each of these trading systems has the potential to generate prices that differ at any point in time from those currently displayed on NASDAQ screens, or through the facilities of the New

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[14] *See, e.g., Private Litigation Under the Federal Securities Laws: Hearings Before the Senate Subcomm. on Securities, Comm. on Banking, Hous., and Urban Affairs,* 103d Cong., 1st Sess. 111 (statement of William R. McLucas, Director of the Division of Enforcement, SEC) (noting the important role that private securities litigation under the Rule 10b-5 plays in deterring securities law violations and compensating victims for fraudulent conduct).

[15] Richard Walker & David Levine, *The Limits of Central Bank's Textualist Approach – Attempts to Overdraw the Bank Prove Unsuccessful,* 26 Hofstra L. Rev. 1, 2 (1997).

York Stock Exchange.[16] The Third Circuit's holding suggests that it could be fraudulent for a broker-dealer to execute NASDAQ or NYSE trades without searching through these disparate alternative trading systems for prices that "maximize the plaintiffs' economic benefit." Pet. App. 16a. The imposition of such a duty threatens to destabilize market structures that have recently undergone extensive regulatory review, Pet. App. 27a, and in which substantial software and hardware investments have been and continue to be made.[17]

II. THE DECISION BELOW IS IN ERROR AND THREATENS TO EXPAND DRAMATICALLY THE SCOPE AND BURDEN OF SECURITIES FRAUD LITIGATION IN THE FEDERAL COURTS.

The decision below commits two major errors. Unless corrected, each has the potential to open the courthouse doors to federal securities law claims that were not contemplated by Congress and against which this Court has repeatedly warned.

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[16] *See generally* Regulation of Exchanges and Alternative Trading Systems, SEC Release No. 34-39884, 63 Fed. Reg. 29,301 (Apr. 29, 1998); Request for Comments, SEC Release No. 34-38672, 62 Fed. Reg. 30,485 (June 4, 1997).

[17] "Since 1994 NASDAQ has spent $160 million on technology development and enhancements." National Association of Securities Dealers, 1997 *Annual Report*, at 13. The NASDAQ market has also agreed to spend at least $300 million through the year 2003 to "provide capacity at a 2 billion share day level, scalable up to 8 billion shares." *Id.* at 45. The NASD also carries on its books data processing equipment and software with an undepreciated cost basis of $232.7 million. *Id.* at 47.

A. The Third Circuit Erred in Holding that an Alleged Breach of a Fiduciary Duty, Which Was Fully Disclosed to the Public and to Regulators, and Which Involved No Manipulation or Deception, Could Constitute Fraud Under Section 10(b).

In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), this Court held that Section 10(b) and Rule 10b-5 can be violated only by conduct "involving manipulation or deception." *Id.* at 473. The Court therefore reversed a Second Circuit decision that had imposed Section 10(b) liability for "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure." *Id.* at 470 (quoting 553 F.2d 1283, 1287 (2d Cir. 1976)). *Santa Fe* also expressly rejected the proposition that "neither misrepresentation nor nondisclosure was a necessary element of the Rule 10b-5 action." *Id.* It further cautioned that any attempt to "bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction . . . would . . . 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.' " *Id.* at 472 (*quoting Hochfelder*, 425 U.S. at 199).

The Third Circuit's decision below committed the very error that this Court warned against in *Santa Fe*. The Third Circuit's decision also contains a dangerous twist that portends a potential explosion in the scope and volume of federal securities law litigation.

The Third Circuit asserted no misrepresentation or lack of disclosure with regard to the existence of a fiduciary obligation of best execution. Nor did the Third Circuit assert misrepresentation or lack of disclosure with regard to the industry's position that execution at NBBO

satisfied the fiduciary obligation of best execution.[18] The Third Circuit also concurred that the SEC was aware of the practice, as was the industry's self-regulatory organization. Pet. App. 26a. The practice was, moreover, described by the NASD in publicly available documents, and the press described the industry's practice and position.[19] The practice was, by all accounts, "no secret." Pet. App. 74a.

That should be the end of the matter here, because *Santa Fe* squarely holds that an ordinary breach of fiduciary duty, without any manipulation or deception, may be actionable under state law but does not violate Rule 10b-5. Put another way, where the defendant has not deceived the plaintiff either about the defendant's duty or about the defendant's actions, there is no fraud. Here, the defendants' duty was defined by the law, the defendants had informed the plaintiffs that they would execute trades in accordance with standard industry practices, and those practices were publicly disclosed to regulators and to the world. Whatever plaintiffs' complaints about the practice might be, they cannot claim to have been defrauded.

The Third Circuit, however, found a misrepresentation where *Santa Fe* holds that there can be none. The Third Circuit reasoned that:

> The alleged misrepresentation here is an implied representation made by the defendants when they agreed to execute plaintiffs' orders that they intended to maximize the plaintiffs' economic gain in the transaction . . . If the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs,

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[18] *See* text accompanying notes 4-5 *supra*.

[19] *See* text accompanying notes 4-6 *supra*.

> plaintiffs insist that the defendants can be found to have made an implied representation that they knew to be false.

Pet. App. 12a.

The error in this logic is glaring. By the Third Circuit's reasoning, any plaintiff can mutate a claim of fiduciary breach into one of fraud by simply asserting that the defendants never intended to honor their fiduciary obligations. Every claim of fiduciary breach in connection with the purchase or sale of securities can thereby be recast as a claim of securities fraud. But this is precisely the attempt to "bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction" against which *Santa Fe* expressly warned. The Third Circuit's conclusion that defendants engaged in a misrepresentation therefore cannot be reconciled with *Santa Fe*, and constitutes clear error.

There was also no breach of fiduciary duty here. The Third Circuit was wrong to define defendants' duty as to "maximize the plaintiffs' economic gain." The duty is to execute trades at the "best *reasonably* available price," and that duty is not to maximize absolutely. Pet. App. 7a. Indeed, the imposition of a duty to "maximize" a customer's "economic gain" would effectively prevent a broker-dealer from earning any profit on a transaction because the intermediary's profit would reduce the customer's returns and would therefore be inconsistent with a duty to "maximize" the customer's gain. But without the opportunity to profit, the broker-dealer has no incentive to remain in business. The Third Circuit's locution of the best execution obligation is thus inconsistent with the very existence of a profit-motivated market populated by brokers, dealers, specialists, or other intermediaries subject to a fiduciary duty of best execution.

Indeed, the breadth of the Third Circuit's logic raises a natural question as to which there can be no satisfactory answer: What disclosure by defendants could have sufficed to prevent a finding of misrepresentation on these facts? The Third Circuit seems to require that, in order to avoid liability for fraud, defendants must accuse themselves of potentially breaching the duty of best execution by disclosing that they intended "not to act in a manner consistent" with that obligation. Pet. App. 12a. Defendants would have to make this disclosure notwithstanding the fact that they assert several objectively reasonable bases upon which to conclude that their conduct complied with the duty of best execution. Pet. App. 26a. Put another way, defendants would have to accuse themselves of a potential breach of fiduciary duty in order to avoid liability for fraud, despite the fact that they had a reasonable basis to believe they were in compliance with their fiduciary obligations.

This result creates an untenable "Catch 22" that Congress clearly never intended to write into the statute. *Santa Fe*, 430 U.S. at 474-77. It also violates the principle that the federal securities laws do not require persons to accuse themselves of breaches of fiduciary duty or "of antisocial or illegal activities," in order to avoid liability for fraud. *GAF Corp. v. Heyman*, 724 F.2d 727, 740 (2d Cir. 1983); *see also United States v. Matthews*, 787 F.2d 38 (2d Cir. 1986); James D. Cox, Robert W. Hillman & Donald C. Langevoort, *Securities Regulation: Cases and Materials* 102-03 (2d ed. 1997) ("The courts and the SEC rationalize the disclosure of basic facts and not characterizations or conclusions as providing all the information for investors to apply their expertise to make informed judgments . . . ").

B. The Third Circuit Erred in Holding that Publicly Disclosed Practices that Were Fully Known to Regulators Could Be Conducted With Scienter.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), this Court held that negligence cannot suffice to establish a cause of action under Section 10(b). Plaintiffs must instead demonstrate that defendants acted with "scienter," which is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 194 n.12. This Court has twice reserved the question of "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) . . . " *Id.*; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) (same). All Courts of Appeal that have addressed the issue have held that recklessness suffices to establish scienter under Section 10(b).[20]

The Securities and Exchange Commission explains that, "[t]he threshold for a finding of recklessness is quite high,"[21] and "requires a high level of culpability – a standard clearly distinguishable from negligence."[22] Indeed, the dominant definition of recklessness[23]

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[20] *See, e.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 n.8 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991) (collecting cases in support of the proposition that *Sunstrand* is the dominant standard); Brief of the United States Securities and Exchange Commission, Amicus Curiae, *In re Silicon Graphics Securities Litigation*, United States Court of Appeals for the Ninth Circuit, No. 97-16240, Nov. 1997, at 6 (available at http://securities.stanford.edu/briefs/sgi/9716240/sec.html).

[21] Brief of SEC, *supra* note 20, at 6.

[22] *Id.*

[23] *See, e.g., Hollinger*, 914 F.2d at 1569 & n.8 (collecting cases); SEC Brief, *supra* note 20, at 6; William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Houston L. Rev. 121, 180 (1997) ("The expression of

demands that an "omission must derive from something more egregious than even white heart/empty head good faith." *Sunstrand Chemical Corp. v. SunChemcial Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). Therefore, "if a defendant genuinely forgot to disclose information or that it never came to mind" then there can be no finding of recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047 ("an omission caused because [defendants] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect") (citation omitted).

The Third Circuit, however, pointed to no evidence that could possibly support a finding of scienter, even if the definition of scienter is expanded to include recklessness. In particular, there is no evidence of a "high level of culpability," or of conduct "more egregious than white heart/empty head good faith," or even that defendants "generally forgot to disclose information." Indeed, if defendants had an evil or culpable intent, then:

- Why would they have disclosed their practices to the Securities and Exchange Commission?
- Why would they have disclosed their practices to the industry's self-regulatory organization?
- Why would they have described their practices in publicly available documents? and
- Why would they have disclosed sufficient information to allow the press to describe their activities in detail?

The Third Circuit had no answer to any of these questions, and we are aware of no instance in which any

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recklessness under section 10(b) that has come to be applied most commonly is the expression in *Sunstrand*.") (citations omitted).

court has found scienter in the face of comparable public disclosure and awareness on the part of regulators as to standard industry practice.

Bereft of any of the traditional bases for finding scienter, the Third Circuit cited a series of allegations by plaintiff that, even if accepted as true, would at worst support a finding of negligence. The Third Circuit found that some "respected members of the brokerage community recognized . . . that trades were available from sources other than the NBBO." Pet. App. 13a. It also found that "an SEC study found clear evidence of a two-tiered market during the class period." *Id.* It further found that the SEC ultimately adopted a regulation effectively requiring that the NBBO be expanded to include price quotations that were previously excluded from the system. *Id.*[24] But even so, allegations that defendants therefore did not "execute the plaintiffs' trade at the best *reasonably* available price," Pet. App. 7a (emphasis supplied) (defining duty of best execution), when pursuing a fully disclosed practice are, at worst, allegations of unreasonable conduct constituting negligence. They most certainly do not satisfy a threshold finding that is "quite high" or "clearly distinguishable from negligence." Nor do they connote culpability, or intent to deceive, manipulate, or defraud.

C. The Third Circuit's Errors Threaten to Expand the Scope and Burden of Securities Fraud Litigation in the Federal Courts Beyond Congressional Intent.

This Court has repeatedly recognized that Section 10(b) "does not by its terms create an express civil

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[24] The correct locution of the effect of the subsequently adopted SEC regulation is to be found in the panel decision at Pet. App. 27a.

remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy. . . . " *Hochfelder*, 425 U.S. at 196; *see also Central Bank*, 511 U.S. at 173; *Musick, Peeler & Garret v. Employers Ins. of Wausau*, 508 U.S. 286, 295 (1993). This Court has also "made no pretense that it was Congress' design to provide the remedy afforded" by the implied private right of action under Section 10(b). *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358 (1991).

In light of the implied nature of the private Section 10(b) remedy, this Court has repeatedly emphasized the need for "adherence to the statutory language." *Central Bank*, 511 U.S. at 173; *see also Santa Fe*, 430 U.S. at 472; *Hochfelder*, 425 U.S. at 197-201. Accordingly, when this Court adopted the scienter requirement for Section 10(b), it underscored the fact that the language of the statute "clearly connotes intentional misconduct." *Hochfelder*, 425 U.S. at 201. It also emphasized that any other reading "would add a gloss to the statute quite different from its commonly accepted meaning." *Id.* at 199. Similarly, when this court construed "fraud" under Section 10(b) as conduct distinct from a breach of fiduciary duty, it warned that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Santa Fe*, 430 U.S. at 473.

The requirement that plaintiffs demonstrate intentional misconduct involving deception is therefore central to the definition of the Section 10(b) cause of action. The Third Circuit's decision below would, however, gut both these essential statutory requirements of any substance. It would allow every breach of fiduciary duty in connection with a securities transaction to be attacked as Section 10(b) fraud. It would also allow assertions of mere negligence in connection with a fully disclosed practice to

masquerade as intentional misconduct satisfying the requirement of scienter.

The net result of the Third Circuit's logic would be a dramatic expansion of the scope of Section 10(b) liability far beyond its already substantial reach, and far beyond any conceivable congressional intent. This expansion of liability would, moreover, promote "vexatious litigation" of the sort against which this Court has already warned, *Blue Chip*, 421 U.S. at 743, and would justify this Court's "concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." *Id.* at 747-48.

CONCLUSION

For the reasons stated above, the Petition for a Writ of Certiorari should be granted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, AND DEAN WITTER REYNOLDS INC.,

Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF THE BOND MARKET ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF THE PETITIONER

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1-TOP

Questions Presented*

Petitioners are registered broker-dealers that make markets in over-the-counter securities, trading for their own accounts with their customers. During the class period alleged in this case, the staff of the Securities and Exchange Commission, petitioners' primary regulator, stated that a broker-dealer's "duty of best execution" of customer market orders is satisfied by "executions * * * based on the NASDAQ national best bid or offer [the 'NBBO'] * * * absent customer instructions to the contrary." Execution of small retail orders at the NBBO was also virtually universal industry practice. Nevertheless, the en banc Third Circuit ruled in this case that a broker-dealer's duty of best execution requires it "to maximize the economic benefit to [its customer]" and that a broker-dealer that routinely executes small customer orders at the NBBO may have violated SEC Rule 10b-5 unless it has affirmatively disclosed to its customer that it will not seek better prices. The questions presented by this ruling are:

1. Whether a broker-dealer that makes no false statement, obeys all customer instructions, and routinely executes small retail orders at the NBBO in accordance with SEC guidance and virtually universal industry practice can be found to have acted with "scienter" as defined in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), because it did not seek better prices for the customer.

2. Whether, if a broker-dealer has a fiduciary duty to customers to seek out better-than-NBBO prices, its failure to seek out such prices can be bootstrapped from a breach of fiduciary duty into fraud, notwithstanding *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), simply by alleging that the firm

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* These questions are set out as stated in the petition.

failed to disclose that it would not seek out such prices.

3. Whether, under the "shingle theory," a market maker has an obligation, in determining prices, "to maximize the economic benefit to the [customer]" rather than merely comply with all laws, all SEC regulatory requirements and guidance, and general industry practice.

TABLE OF CONTENTS

	PAGE
Questions Presented	i
Table of Authorities	iv
Interest of the Amicus Curiae	1
Introduction and Summary of Argument	3
ARGUMENT	5
I. The Court of Appeals Erred in Determining That Broker-Dealers Acting Within the Bounds of Regulatory Guidance and Established Industry Practice Possessed the Scienter to Defraud Their Customers	5
II. The Court of Appeals' Erosion of the Scienter Requirement Will Create Uncertainty in the National Securities Markets	10
CONCLUSION	11

PAGE

TABLE OF AUTHORITIES

Cases

Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017 (4th Cir. 1997) 9

Chiarella v. United States, 445 U.S. 222 (1980) 5

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) ... *passim*

Messer v. E.F. Hutton & Co., 847 F.2d 673 (11th Cir. 1988) 10

Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286 (1993) 10

Platsis v. E.F. Hutton & Co., 946 F.2d 38 (6th Cir. 1991), *cert. denied*, 503 U.S. 984 (1992) 9, 10

Santa Fe Indus. v. Green, 430 U.S. 462 (1977) i

Statutes & Rules

15 U.S.C. § 78aa (1997) 11

Securities Exchange Act of 1934 § 10(b) ..... *passim*

SEC R. 10b-5 ..... *passim*

U.S. Sup. Ct. R. 37.2(a) 1

Other Authorities

Inducements for Order Flow, A Report to the Board of Governors, National Association of Securities Deal ers (July 1991) 6

Market 2000: An Examination of Current Equity Market Developments, Study V, Best Execution, 1994 SEC LEXIS 136 (Jan. 1994) 5, 6, 7, 8

PAGE

Notice of Proposed Rule Change, Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042 (Nov. 1, 1984) 7

Order Execution Obligations, Exchange Act Release No. 34-36310, 60 S.E.C. Docket 919 (Sept. 29, 1995) 7

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF THE BOND MARKET ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF THE PETITIONER

Interest of the *Amicus Curiae*

The Bond Market Association submits this brief as *amicus curiae* with the consent of the parties as specified in this Court's Rule 37.2(a).[1] The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt

[1] Copies of the letters of consent have been filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than the *amicus curiae*, its members, and their counsel made a monetary contribution to the preparation and submission of this brief.

securities in the United States and international markets. The Association's members deal in a wide variety of public and private debt securities. The Association's member firms account for in excess of 95% of all primary issuance and secondary trading activity in the domestic debt capital markets.

Since its inception in 1976,[2] the Association has addressed significant issues that confront the securities industry, fostered sound credit, business and trading practices for participants in the bond markets, and undertaken initiatives to improve market efficiency. The Association has been particularly active in addressing issues relating to the regulation of the industry by providing its views on securities legislation and regulation and participating in the development of trading practice standards.

The Bond Market Association has an interest in the outcome of this case. The debt markets, like the over-the-counter equity markets traded through the facilities of NASDAQ, are heavily regulated by the Securities and Exchange Commission ("SEC") and self-regulatory organizations ("SROs") such as the New York Stock Exchange and the National Association of Securities Dealers ("NASD"). In addition to issuing the rules and regulations that govern industry practice, the SEC and the SROs, in their role as market regulators, frequently offer guidance to bond market participants in the form of rule proposals, releases and studies of industry practice. The Association's members, as major dealers in this country's bond market, rely on this guidance in establishing trading practices and making business decisions.

The en banc Third Circuit's decision directly calls into question the extent to which broker-dealers and bond market

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[2] The Bond Market Association was previously named the Public Securities Association.

participants may continue to adhere to SEC and SRO guidance and wide-spread industry practice in establishing trading practices without being retrospectively exposed to liability for fraud for having done so. The decision held that a broker-dealer could be found liable for fraud — a manipulative or deceptive act — for engaging in a trading practice that was consistent with SEC and SRO guidance and was virtually universally adopted in the industry. This decision, if allowed to stand, would have industry-wide impact, as it would leave broker-dealers without an important guidepost by which to develop business and trading practices. Much of the litigation regarding the conduct of participants in the debt markets, like in the over-the-counter equity markets, is brought under Section 10(b) and Rule 10b-5. The Association has a vital interest in ensuring that the securities laws are interpreted reasonably and consistently, so as to allow its members to act in an environment of legal certainty that will provide stability in the marketplace. Thus, *amicus* submits this brief to assist this Court in its evaluation of the petition for certiorari.

Introduction and Summary of Argument

This Court has held that a cause of action under Section 10(b) and Rule 10b-5 will lie only in cases of actual fraud, in which the defendant possesses the intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The decision of the en banc Court of Appeals marks a significant departure from this standard.

This case deals with the trading practices of three broker-dealers participating in the NASD Automated Quotation ("NASDAQ") over-the-counter securities market. During the time period at issue in the case, the three broker-dealers executed small customer market orders based on a pricing system called the NASDAQ national bid and best offer

("NBBO"). The respondents, individual investors who placed trade orders with the broker-dealers, alleged that the practice of executing at the NBBO did not achieve the best price possible for certain trades, and thus, the broker-dealers, by always executing at the NBBO price, intentionally defrauded the investors. (Pet. 8).

The en banc Court of Appeals held that the broker-dealers have a "duty of best execution" which requires them to maximize the economic interests of their clients. (Pet. App. 7a). The court found that a reasonable jury could find not only that the broker-dealers breached their duty of best execution, but that the broker-dealer's conduct could be found "at least reckless, if not intentional," and thus a fraud in violation of Section 10(b) and Rule 10b-5. (Pet. App. 13a).

This decision was reached in apparent disregard of the fact that both the SEC and the NASD had issued statements prior to or during the class period taking the position that in the context of small orders in the NASDAQ market, a broker-dealer's duty of best execution is satisfied by executing a trade at the NBBO. In addition, although the panel acknowledged that "execution of customer orders at the NBBO was a practice 'widely if not almost universally followed' in the securities industry during the class period," the panel failed to elucidate any rationale supporting liability consistent with the requirement of an actual intent to deceive, manipulate or defraud. (Pet. App. 15a).

The regulatory context, together with the open and near universal nature of the market practices in this case, effectively eliminate the "scienter" requirement established in *Hochfelder*. In a highly regulated industry like the over-the-counter debt markets, a broker-dealer, following a well-accepted industry practice that is consistent with regulatory guidance, cannot as a matter of law act with the fraudulent intent required by

Hochfelder. Broker-dealers must be able to gauge their practices by using the pronouncement of regulators and industry practices as guideposts.

ARGUMENT

I. The Court of Appeals Erred in Determining That Broker-Dealers Acting Within the Bounds of Regulatory Guidance and Established Industry Practice Possessed the Scienter to Defraud Their Customers

This Court has historically limited Rule 10b-5 actions to "intentional or willful conduct designed to deceive or defraud investors . . . ." *Hochfelder*, 425 U.S. at 199. This Court has held that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980). The en banc Court of Appeals, however, found a cause of action to lie where the conduct of the broker-dealers fell far short of deceit or fraud. The trading practice at issue in this case was consistent with regulatory guidance and was designed in accordance with industry practice. Thus, the open practice of these broker-dealers could not also have also been "designed to deceive and defraud investors." Conformity to regulatory guidance and industry practice shows, particularly in a heavily regulated industry like the securities markets, the antithesis of the intent required by *Hochfelder*.

At the center of this case is what has been termed the "duty of best execution." The decision below turned on whether the petitioner broker-dealers' practice of trading small orders at the NBBO was a breach of that duty. The duty of best execution has eluded clear interpretation. According to the SEC, the duty is derived from concepts of common law agency and from the "shingle theory," which holds that "a broker-dealer impliedly

represents at the outset of a securities transaction that it will deal with its customers fairly and in accordance with the standards of the industry." *Market 2000: An Examination of Current Equity Market Developments, Study V, Best Execution*, 1994 SEC LEXIS 136, *2-3 & n.7 (Jan. 1994). The duty of best execution is an extension of the shingle theory and, in general terms, according to the SEC, requires "that [a] broker endeavor, using due diligence, to obtain the best execution possible given all of the facts and circumstances." *Id.* at *7-8. However, as the en banc Court of Appeals recognized, the SEC's view of the precise contours of the duty of best execution is constantly evolving. *Id.*

The SEC and the NASD have both made clear pronouncements that the execution of small over-the-counter stock trades at the NBBO satisfies the duty of best execution. In July of 1991, more than a year before the beginning of the class period, a special committee appointed by the NASD Board of Governors and headed by former SEC Chairman, David S. Ruder, issued a report which stated in relevant part:

> [The committee] believes that when orders are executed at the best current displayed bid or offer that investors receive best execution of their small-sized orders . . .

Inducements for Order Flow, A Report to the Board of Governors, National Association of Securities Dealers, at 28 (July 1991). In addition, in January of 1994, midway through the class period, the SEC issued an in-depth examination of the duty of best execution which expressly addressed the best execution obligations of broker-dealers trading in the NASDAQ market. *Market 2000*, 1994 SEC LEXIS 136, at *15. The report distinguished the over-the-counter NASDAQ market, which relies on geographically dispersed dealers, from an

exchange market based on order interaction on a trading floor, and found that in the NASDAQ market:

> it is reasonable to accept quote-based executions of market orders based on the NASDAQ best bid or offer as consistent with best execution, absent customer instructions to the contrary.

Id. These unequivocal statements of policy supported a widely followed industry practice and provided the broker-dealers in this case a reasonable basis to believe that trading at the NBBO satisfied the duty of best execution.

In addition, in 1984, the SEC and NASD created an automated system for executing small trades of over-the-counter stock called the Small Order Execution System ("SOES"). (Pet. App. 45a). During the class period, the SOES system automatically directed orders to the market maker displaying the best bid or offer (NBBO) price at the time of the trade. *Id.* The SOES system was specifically designed to provide the industry with "an enhanced mechanism for the efficient and economic execution and clearance of transactions in over-the-counter securities." *Notice of Proposed Rule Change*, Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042, 44,044 (Nov. 1, 1984).

After the class period, the SEC reaffirmed that execution at the NBBO has long been viewed as satisfying best execution obligations. *Order Execution Obligations*, Exchange Act Release No. 34-36310, 60 S.E.C. Docket 919 (Sept. 29, 1995). In addition, the NASD's General Counsel provided an affidavit in this case stating that, "[t]he NASD has viewed [execution at the NBBO] as consistent with the duty of 'best execution' that broker-dealers assume when they accept customer orders." Pet. App. 50a (bracketed material supplied by the district court).

In determining that the broker-dealers in this case could be found to have acted with intent to defraud their customers, the en banc court did not even consider this clear SEC and NASD guidance regarding execution at the NBBO. The court instead referred to other statements in the SEC's *Market 2000* report regarding the duty of best execution that are more general in nature. The opinion asserts that :

> the SEC has consistently taken the position that the evolving nature of the markets requires a broker-dealer to 'periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order.'

(Pet. App. 9a) (quoting *Market 2000 Report*, 1994 SEC LEXIS 136, at *11-12). The district court also noted other SEC and NASD statements made during the class period that were more equivocal as to whether execution at the NBBO in all circumstances and for all times always satisfied the duty of best execution. (Pet. App. 51a).

The broker-dealers' practice was consistent with the only clear statements regarding best execution issued by the SEC and the NASD during the class period. The fact that other, more general statements regarding the duty of best execution were also made by the regulators during the same time period cannot make reliance on the unequivocal pronouncements bad faith or deceit. If in fact the regulators believed executing small orders at NBBO was fraudulent, the industry had every reason to believe they would have said so — and not indicated to the contrary. Given these facts and the record here, the broker-dealers cannot be found to have been acting with the intent to defraud.

The en banc Third Circuit opinion to the contrary is in conflict with the decisions of other circuits. In *Banca Cremi, S.A. v. Alex. Brown & Sons*, 132 F.3d 1017 (4th Cir. 1997), the case turned on whether the defendant had the duty to disclose mark-ups that the plaintiff claimed were fraudulent. *Id.* General guidance was available from case law to the effect that "[a] mark-up is excessive when it bears no reasonable relation to the prevailing market price." *Id.* at 1033 (citation omitted). The Board of Governors of the NASD had determined that "[a]lthough each case requires an independent analysis . . . as a general guideline, a five percent mark-up is reasonable." *Id.* The Fourth Circuit found that "the alleged presumption of scienter in the instant case is rather difficult to square with the uncontested fact that Epley and Alex. Brown stayed within the NASD five percent guideline on all of the markups with two exceptions." *Id.* at 1037 n.26. The court further found that "[i]n light of the defendants' adherence to an industry-wide guideline, the plaintiff has rather a heavy burden to persuade that the defendants nevertheless knew that their [conduct was fraudulent.]" *Id.*

Similarly, in *Platsis v. E.F. Hutton & Co.*, 946 F.2d 38 (6th Cir. 1991), the Sixth Circuit found that adherence to industry practice precludes a finding of intent to defraud. The trial court had held that the defendant's failure to disclose the amount of production credits and mark-ups was a "deliberate" and "material" omission giving rise to an action under Rule 10b-5. The appellate court reversed, holding that:

> Since very few brokers disclosed these credits at the time these events took place and there was no established regulatory duty to disclose these items, an intent to deceive or an 'extreme departure from the standards of ordinary care' could not be established

> merely by the omission of this information in the absence of special circumstances.

Id. at 41. *See also Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 679 (11th Cir. 1988) (no scienter where broker "made a reasonable decision well within the bounds of accepted industry practice").

As these opinions demonstrate, this Court should grant certiorari to review the Third Circuit en banc decision which finds intent to defraud based on conduct that can only be interpreted as good faith, and thus effectively eliminates the scienter requirement established by this Court in *Hochfelder*.

II. The Court of Appeals' Erosion of the Scienter Requirement Will Create Uncertainty in the National Securities Markets

One of this Court's express goals in establishing limits for the Rule 10b-5 action has been "to promote clarity, consistency, and coherence for those who rely upon, or are subject to, 10b-5 liability." *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 295 (1993) (citations omitted). The *Hochfelder* formulation, limiting 10b-5 actions to cases of actual fraud, has provided the industry with clear guidance. The industry is on notice that fraudulent acts can give rise to liability, and the industry participants conduct their business accordingly. The en banc Court of Appeals decision, on the other hand, will result only in confusion. If broker-dealers may no longer rely on regulatory guidance and industry practice, they will have lost two of the important touchstones by which they have, in the past, evaluated the propriety of their business practices. The clarity of the legal and regulatory scheme that governs the securities industry will be seriously compromised, leading to confusion and market inefficiencies.

The Third Circuit decision will have an impact on securities markets nationwide. As a result of the electronic links between broker-dealers all over the country, the securities markets are national, not regional. And, because of the broad venue provisions in the securities laws, broker-dealers around the country are potentially within the reach of Third Circuit law. *See* 15 U.S.C. § 78aa (1997). This Court should grant certiorari to restore clarity to Section 10(b) and Rule 10b-5.

CONCLUSION

The petition for a writ of certiorari should be granted.

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

INTEREST OF THE AMICI CURIAE 1

SUMMARY OF ARGUMENT 2

I. THIS COURT HAS RECOGNIZED THAT CERTAINTY IS INTEGRAL TO THE OPERATION OF THE SECURITIES MARKETS 5

II. ADAPTING REGULATORY REQUIREMENTS TO RAPIDLY CHANGING INFORMATION TECHNOLOGY SHOULD BE THE PROVINCE OF EXPERT REGULATORY BODIES 7

A. The Capability of Information Technology Has Grown Rapidly During and Since the Class Period 8

B. Securities Regulators Must Strike a Balance in Adapting Existing Rules to New Information Technology 10

Page

C. An Expert Agency is Uniquely Suited to Adapt the Regulatory Structure to Changes in Information Technology 16

III. THE BREADTH OF THE THIRD CIRCUIT'S OPINION CONFLICTS WITH RULINGS OF THIS COURT THAT SECTION 10(b) CAPTURES ONLY FRAUD 18

CONCLUSION 20

TABLE OF AUTHORITIES

Cases **Page(s)**

Anixter v. Home-Stake Prod. Co.,
77 F.3d 1215 (10th Cir. 1996) 7

Banca Cremi v. Alex, Brown & Sons,
132 F.3d 1017 (4th Cir. 1997) 6, 19

Blue Chip Stamps v. Manor Drug Stores,
421 U.S. 723 (1975) 18

Central Bank v. First Interstate Bank,
511 U.S. 164 (1994) 5, 6, 7

Chiarella v. United States,
445 U.S. 222 (1980) 6

United States v. Cochran,
109 F.3d 660 (10th Cir. 1997) 7

Commodity Futures Trading Comm'n
v. Schor, 478 U.S. 833 (1986) 16

Dirks v. SEC, 463 U.S. 646 (1983) 6

Ernst & Ernst v. Hochfelder,
425 U.S. 185 (1975) 15, 18

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513 U.S. 561 (1995) 6

In re Merrill Lynch Sec. Litig.,
911 F. Supp. 754 (D.N.J. 1995) 7, 16, 17

Page(s)

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439 U.S. 551 (1979) 16

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(3d Cir. 1998) (*en banc*) ..... *passim*

Pinter v. Dahl, 486 U.S. 622 (1988) 6

Reno v. ACLU, 117 S. Ct. 2329 ..... 9, 10

Santa Fe Indus. v. Green,
430 U.S. 462 (1977) 18

Schreiber v. Burlington N., Inc.,
472 U.S. 1 (1985) 6

United States v. Cochran,
109 F.3d 660 (10th Cir. 1997) 7

United States v. O'Hagan,
117 S. Ct. 2199 (1997) 18

Upton v. SEC,
75 F.3d 92 (2d Cir. 1996) 7

Page(s)

Statutes, Regulations, and Rules

National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 17

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Securities Act of 1933 § 5, 15 U.S.C. § 77e 12

Securities Act of 1933 § 10, 15 U.S.C. § 77j 12

Securities Act of 1933 § 12(1), 15 U.S.C. § 12 6

Securities Exchange Act of 1934 § 6, 15 U.S.C. § 78f 11

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) ..... *passim*

Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 14 6

Securities Exchange Act of 1934 § 23(a), 15 U.S.C. § 78w(a)(1) 16

17 C.F.R. § 230.153 11

17 C.F.R. § 230.153a 11

17 C.F.R. § 230.153b 11

17 C.F.R. § 230.174 11

Page(s)

17 C.F.R. § 230.420 11

17 C.F.R. § 240.10b-5 ..... *passim*

17 C.F.R. § 240.15c3-3(e) 7

17 C.F.R. § 275.206(4)-1(a) 14

Sup. Ct. R. 37.3 1

Sup. Ct. R. 37.6 1

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BG&E Corp., SEC No-Action Letter, 1997 No-Act. LEXIS 14 (Jan. 6, 1997) 13

Division of Market Regulation, S.E.C., *Market 2000, An Examination of Current Equity Market Developments*, 1994 SEC LEXIS 136 (Jan. 1994) 15

ITT Corp., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 895 (Dec. 6, 1996) 13

Munder Capital Management, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 518 (May 17, 1996) 14

Net Roadshow, Inc., SEC No-Action Letter [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,367 (Sept. 7, 1997) 12

Page(s)

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Order Execution Obligations, Exchange Act Release No. 37619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996) 12

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INTEREST OF THE AMICI CURIAE[1]

The Securities Industry Association ("SIA") is the trade association representing the interests of nearly 800 securities firms, employing over 380,000 individuals. SIA members - including broker-dealers, mutual fund complexes and investment banks - are active in all aspects of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and generates $270 billion of revenues in the U.S. economy.

The Security Traders Association ("STA") is the only trade association in the securities industry that represents *individual* practitioners, many of whom are direct participants in the National Association of Securities Dealers Automated Quotation system (the "NASDAQ" market). As "market makers," many STA members share the responsibility of maintaining liquid and transparent markets in NASDAQ-listed stocks. Among the STA's 7,500 members in Canada, France, and the United States are traders and registered representatives from broker-dealers, institutions, and specialist firms.

Together, *Amici Curiae* represent a significant portion of the market professionals affected by the ruling below. *Amici* are vitally concerned that the Third Circuit's opinion in this case will undermine the certainty that is essential for the efficient execution of well over one billion transactions annually on the NASDAQ market. That certainty will be eviscerated if reliance on then-current regulatory and industry standards for execution of retail

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[1] Letters of consent to the submission of this brief have been filed with the Clerk of the Court pursuant to Rule 37.3. Pursuant to Rule 37.6, counsel for *amici* states that no counsel for a party authored this brief in whole or in part and no person, other than *amici* or their counsel made a monetary contribution to the preparation of this brief.

transactions can be displaced, years after the fact, by a single appeals court's application of a generic antifraud proscription. The Third Circuit's ruling could produce a flood of litigation that would impair over 1.6 billion transactions annually based on its second-guessing industry-wide applications of then-existing technology.

The SIA and STA are familiar with the issues raised in the Petition for a Writ of Certiorari and believe that their participation in this *amici curiae* brief would be helpful to the Court. *Amici* submit that the District Court correctly rejected plaintiffs' claims and that the Third Circuit's *en banc* decision should be reversed.

SUMMARY OF ARGUMENT

Certainty and predictability are critical to the securities markets. The tremendous trading volume common to today's markets requires precision as to the obligations of all parties to these transactions. The issue presented to this Court is whether, as a matter of law, petitioners could commit securities "fraud" by relying on the national best bid and offer price ("NBBO") - in accordance with regulatory pronouncements and industry-wide practice - in the execution of small retail transactions on the NASDAQ market during the class period. The Third Circuit, *en banc*, determined that the mere *possibility* of the availability of alternative quotes precludes summary judgment on these issues. *Amici* advance two core arguments that compel the need for this Court's review of the Third Circuit's decision.

First, given the rapid pace of change in information technology affecting the securities markets, it is critical that market participants be able to rely on existing regulatory guidance in fulfilling their "duty of best execution." The extent of that change becomes apparent in contrasting the significant advances during the 1992-94 class period and in the interim period leading to the Third Circuit's ruling earlier this year. Capabilities now taken for granted were in their infancy as recently as the class

period. For example, during the class period, the Securities and Exchange Commission's ("SEC" or "Commission") electronic filing system, EDGAR (Electronic Data Gathering, Analysis, and Retrieval) was not yet fully operational. The number of U.S. electronic mail users more than doubled during the class period alone and, by the time the Third Circuit issued its opinion, doubled again to 55 million users.

The translation of these technological changes into marketplace obligations must be left to the regulatory agencies overseeing the marketplace on a "real time" basis. As this Court has recognized repeatedly, these regulatory bodies, with their unique and specialized expertise, are best equipped to determine when market professionals must utilize technological improvements. These capabilities are constantly evolving. Through a series of releases, no-action letters[2] and other public pronouncements, the SEC and other regulatory bodies have delineated carefully the extent to which market participants can avail themselves of new technology. It is telling that, as part of this process, after input from market participants, the SEC issued new regulations after the class period concerning whether sole reliance on the NBBO price satisfied broker-dealer obligations to customers. The Third Circuit, at the behest of private litigants, has usurped the role properly accorded to an expert agency and attempted to restate regulatory standards (without the safeguards that accompany SEC rulemaking).

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[2] "A no action letter provides analysis of a specific transaction; interpretative letters provide an analysis of a specific statute, rule, or regulation in the context of an actual fact situation. No-Action and interpretative letters are issued by the Commission staff, not the full Commission, and do not bind the Commission." 1 Louis Loss & Joel Seligman, Securities Regulation 532-33 n.29 (3d ed. 1998).

Second, the breadth of the Third Circuit's application of an implied right of action under a generic securities antifraud provision - Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) - conflicts with the rulings of this Court and others regarding the plain language of the federal securities laws and the proper scope of implied rights and remedies under Section 10(b). Congress has made clear, and this Court repeatedly has stressed, that the goals of the securities laws must be balanced with the need for certainty that is critical to the operation of the securities markets.

The Third Circuit's *en banc* reversal of the District Court's opinion turned on a determination that the obligations of broker-dealers in executing small orders for customers had evolved, by the class period, because of the Third Circuit's *belief* that "both technology and over-the-counter markets had developed to the point where it was feasible to maximize the economic benefit to the client by taking advantage of better prices than the NBBO." *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 272 (3d Cir. 1998) (*en banc*). The Third Circuit's opinion suggests that implied liability for a vast number of securities transactions should rest on a trier of fact's determination of the proper legal standard, which is dependent on the jury's determination of what is "feasible" under a best execution obligation that itself is undefined. Making these determinations well after the fact is inconsistent with the scope of implied remedies under Section 10(b) and the certainty that is essential to the marketplace.

I. THIS COURT HAS RECOGNIZED THAT CERTAINTY IS INTEGRAL TO THE OPERATION OF THE SECURITIES MARKETS

As Section 10(b) provides no express private right of action, the need for certainty has guided this Court's interpretation regarding the scope of any liability in an implied action under that provision. *See, e.g., Central Bank v. First Interstate Bank*, 511 U.S. 164, 188 (1994) (stressing that certainty and predictability are crucial to the securities markets). In *Central Bank*, a purchaser of public improvement bonds brought suit under Section 10(b) and Rule 10b-5 thereunder, alleging that the petitioner bank, by failing to obtain an independent real estate appraisal, aided and abetted a fraud. *Id.* at 167-69. Observing that the plain language of the statute did not confer a private litigant with the right to sue under an aiding and abetting theory, this Court rejected the respondent's claim and reversed. *Id.* at 191. The Court noted that extending liability under 17 C.F.R. § 240.10b-5 ("Rule 10b-5") to aiders and abettors could be a disservice to the public as the expenses associated with protracted litigation can create uncertainty in the marketplace and increase the costs of raising capital. *Id.* at 189.[3]

Central Bank reiterated this Court's long-standing concern in its Section 10(b) jurisprudence regarding the need by

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[3] Congress reaffirmed this judgment in 1995, when it adopted the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 ("PSLRA"). The PSLRA added Section 20(f) to the Exchange Act, expressly authorizing the *Commission* to initiate proceedings against parties who aid and abet securities violations. In doing so, Congress overruled this Court's *Central Bank* decision insofar as it might apply to the SEC, but left intact this Court's holding, and its reasoning, that denied such an action to private litigants.

market participants for certainty and predictability. *See, e.g., Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 357 (1991) (holding that a claim under Section 10(b) is governed by the statute of limitations in the Securities Act of 1933 and the Exchange Act because "the federal interests in predictability and judicial economy counsel the adoption of one source"); *Dirks v. SEC*, 463 U.S. 646, 659 (1983) ("Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed."); *Chiarella v. United States*, 445 U.S. 222, 235 & n.20 (1980) (noting that broad construction of Section 10(b) would be "inconsistent with the careful plan that Congress has enacted for regulation of the securities markets").[4]

Following the lead of this Court, lower courts too have cited the need for stability and certainty in the marketplace in reaching decisions concerning federal securities laws. *See, e.g., Banca Cremi v. Alex. Brown & Sons*, 132 F.3d 1017, 1035 (4th Cir. 1997) (holding that plaintiff failed to show that broker committed securities fraud by charging excessive markups and not informing customer of these charges because, in part, the SEC "abandoned an effort to administratively require such

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[4] This Court's emphasis on the need for certainty in the securities markets is not limited to cases arising under Section 10(b). *See, e.g., Gustafson v. Alloyd Co.*, 513 U.S. 561, 578 (1995) (noting that extension of liability under Section 12(2) of the Securities Act would "impair[] the stability of past transactions"); *Pinter v. Dahl*, 486 U.S. 622, 652 (1988) (noting, in case arising under Section 12(1) of the Securities Act of 1933, 15 U.S.C. § 12, that the securities markets are an "area that demands certainty and predictability"); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11-12 (1985) (rejecting broad interpretation of Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 14, because it would inject uncertainty into tender offer process).

disclosures"); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226-27 (10th Cir. 1996) (citing *Central Bank* for the proposition that "certainty and predictability are crucial to securities markets."); *accord Upton v. SEC*, 75 F.3d 92, 98 (2d Cir. 1996) (overturning censure of securities broker because SEC's interpretation of 17 C.F.R. § 240.15c3-3(e) created "substantial uncertainty"). *See also United States v. Cochran*, 109 F.3d 660, 665-67 (10th Cir. 1997) (reversing conviction where conduct was not expressly prohibited).

The need for certainty and predictability has become more acute with the increase in the volume of trading in the NASDAQ market. From more than 332 million trades in 1990, NASDAQ saw its volume increase to more than 1.6 billion in 1997. *See NASDAQ Total Volume*, IDD Information Service, May 28, 1998, *available in* LEXIS, Quote Library, HIST File. The sheer volume of these transactions underscores that judicial fidelity to certainty in the securities markets is well placed.

II. ADAPTING REGULATORY REQUIREMENTS TO RAPIDLY CHANGING INFORMATION TECHNOLOGY SHOULD BE THE PROVINCE OF EXPERT REGULATORY BODIES

Nowhere is the need for certainty more pronounced than in addressing the application of burgeoning information technology capabilities to the securities markets. As the District Court below observed, "[i]n a modern market that involves both rapid evolution of technology and large-scale expansion of the use of that technology, a state of constant and sometimes radical change may, in one sense, represent the 'status quo.'" *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. 754, 772 (D.N.J. 1995). The SEC, in particular, is engaged in an ongoing deliberative process to adapt its implementation of New Deal-era statutes to this rapidly-changing environment. Federal courts, acting without the benefit of notice and comment that is required to accompany agency rulemaking, should be loathe to adopt new regulatory

requirements on an *ad hoc* basis in the place of the expert regulatory agency's guidance on such issues.

A. The Capability of Information Technology Has Grown Rapidly During and Since the Class Period

Since the issue of best execution is framed as an evolving legal standard, it is important to place in context the vast changes in information technology available to the securities market. Over the last decade, the capability and availability of information technology has grown exponentially. It is well established that, in the computer industry, computing power doubles every 18 months, *see* Pam Woodall, *Survey of the World Economy (1): The Hitchhiker's Guide to Cybernomics - New Technology and Globalisation are Changing the World*, Economist, Sept. 28, 1996, *available in* 1996 WL 11247312, while the price of computers declines at an annual rate of twenty percent. *See* Robert Adams, *Social Contexts of Technology (Technology and the Rest of Culture)*, Social Research, Sept. 22, 1997, *available in* 1997 WL 11171193. For example, in 1988, the average price of a personal computer equipped with a CD-ROM drive was approximately $4,500. *See* Ralph T. King, *The Price is Right: That's Why the Purchases of Multimedia Machines Have Begun to Take Off*, Wall St. J., Mar. 21, 1994, *available in* 1994 WL-WSJ 300704. By 1992, the price of that same type of personal computer had dropped to $2,500, and a year later, the average price had fallen to $2,000. As prices dropped, sales rose from 87,000 units in 1992 to 1.7 million units in 1993. *Id.*

Similarly, the price of larger-scale computing technology, like that used in large brokerage firms, also dropped dramatically in the late 1980s and 1990s. The power of a mainframe computer as measured in MIPS - a computer's ability to process one million pieces of information per second - has dropped from $400,000 per MIP in 1980, to $117,000 in 1989, to $34,000 in 1994. *See The Mainframe Bytes Back*, U.S. News & World Rep., Oct. 17, 1994, at 68. Not only is today's $2000 laptop computer many

times more powerful than a $10 million mainframe computer was in the mid-1970's, *Survey of the World Economy*, but "[a]t one one-hundredth of one percent of what comparable computer power cost a quarter-century ago, the amount of it that now can be carried in a shirt pocket is probably comparable to what was available to NASA itself in first venturing to the moon." *Social Contexts*.

As a result of the drop in computing prices and the availability of faster and more powerful machines at lower prices, the use of information services has grown dramatically. For instance, the use of electronic mail through the Internet, which was developing during the class period, is now a vital tool for many businesses.[5] In 1992 - the first year of the class period - only five million Americans used electronic mail, sending approximately 10 million messages a day. Jon G. Auerbach, *Getting the Message: As E-mail Booms, It Is Changing the Frequency*, Wall St. J., June 16, 1997, *available in* 1997 WL-WSJ 2424254. By the end of the class period in 1994, 13 million Americans used electronic mail, sending approximately 28 million messages daily. *Id.* In 1997, the year prior to the Third Circuit's opinion in this case, 55 million Americans used e-mail, sending approximately 150 million messages a day. *Id.*

These changes have improved dramatically investor access to key information. One of the most important examples

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[5] The Internet is a worldwide network of interconnected computers that allows a person using a computer linked to the network to communicate with other network users. One means of communicating through the Internet is by electronic mail ("e-mail"). *See Reno v. ACLU*, 117 S. Ct. 2329, 2334 (1997). E-mail enables a person to send an electronic message, much like a letter sent through the regular mails, to another person who has a computer connected to the same network. *See id.* at 2335.

can be seen in the SEC's EDGAR system on which most public companies now submit their filings. Since EDGAR became fully operational in 1996, these filings have been available through the SEC's site on the World Wide Web.[6] SEC, *Report to Congress: The Impact of Recent Technological Advances on the Securities Markets* (1997) [hereinafter *Report to Congress*]. This site is viewed an average of 500,000 times a day. *See id.* The SEC's utilization of information technology has altered fundamentally the market it must regulate.

B. Securities Regulators Must Strike a Balance in Adapting Existing Rules to New Information Technology

Information technology innovations affect all aspects of the securities markets. Each innovation generates a myriad of untested issues under the federal securities laws. Regulators must strike a balance between fostering the efficiency afforded by improving technology while upholding the policy objectives underlying long-standing regulatory requirements. This regulatory balancing is evident in virtually every aspect of the securities regulatory system:

- **Prospectus Delivery Requirements.** Rules promulgated under the Securities Act impose certain document delivery requirements to fulfill disclosure obligations in a

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[6] The World Wide Web is a segment of the Internet through which users may search for and retrieve information stored in remote computers. *See Reno*, 117 S. Ct. at 2335. Some of the information contained on the world wide web takes the form of "web pages" or "web sites," which consist of sets of information, typically including images and "links" to other web sites. Each web page has a unique identifying address, much like a telephone number. *See id.*

securities offering. *See, e.g.*, 17 C.F.R. § 230.174. A prospectus detailing material information regarding the offering must be delivered to purchasers prior to or at the same time the purchasers are provided with a sales confirmation. *See* 17 C.F.R. §§ 230.153, 230.153a, 230.153b. The proliferation of e-mail affords companies the capacity to expedite the document delivery process at a fraction of the cost. At the same time, electronic delivery does not allow issuers to meet traditional formatting requirements - such as bold-face type or the use of red ink for portions of preliminary prospectuses - developed when paper was the only available medium for distribution. *See* 17 C.F.R. § 230.420. The SEC has sanctioned electronic delivery in situations in which investors are given adequate notice, the document is reasonably available to investors and the system generates some reasonable assurance that the investor received the information. General guidelines allow for reasonable attempts to deliver the same information in both electronic and paper formats. *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Exchange Act Release No. 36,345, 60 Fed. Reg. 53,468, 1995 SEC LEXIS 2662 (Oct. 6, 1995) [hereinafter *October 1995 Release*]. Further deliberation and review of comment letters culminated in the adoption of several amendments to SEC regulations. *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7289, Exchange Act Release No. 37,183, 61 Fed. Reg. 24,652, 1996 SEC LEXIS 1298 (May 9, 1996).

• **Bulletin Board Marketplaces.** Several issuers have found in Internet technology the capacity to create an on-line market for their securities. The SEC was compelled to face the question of whether such markets should be required to register as a "national securities exchange" under Section 6 of the Exchange Act, 15 U.S.C. § 78f. In a series of no-action letters, the Commission's staff has indicated that such registration (and other potential regulatory requirements) could be avoided if certain safeguards were built into the marketplace. These safeguards included (i) restrictions regarding the handling of investor funds, (ii) disclosure to investors regarding the risks of investment in

illiquid securities and (iii) disclosure of broker-dealer registration requirements to investors simultaneously posting buy and sell quotations. *See, e.g.*, *Spring Street Brewing Co.*, SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201 (Apr. 17, 1996); *Real Goods Trading Corporation*, SEC No-Action Letter [1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226 (June 24, 1996).

• **Internet "Roadshows."** A roadshow is a sales effort led by an issuer's senior management and its underwriter, usually before the registration statement becomes effective, *i.e.*, the day the SEC staff approves the registration. *See* 1 Loss & Seligman, *supra* note 2, at 341. Although Section 5 of the Securities Act, 15 U.S.C. § 77e, bars contracts for sale of securities during the period the registration statement is awaiting SEC approval, oral offers or written ones by means of a prospectus meeting the requirements of Section 10 of the Securities Act, 15 U.S.C. § 77j are permissible. *See id.* at 466-71. The roadshow audience typically is limited to a relatively small group of institutional investors. *See id.* at 341. Advances in information technology have created the opportunity for investors now to view the roadshow on a designated web site at their convenience. One potential impediment rests in the concern that the transmission of the roadshow through the Internet might itself be considered a "prospectus." The Commission's staff has provided no-action guidance that it would not assert such a claim based on certain representations made by sponsors of services offering Internet roadshows. Given the inability to ensure that each person present at electronic roadshows was handed a copy of the prospectus, the sponsors indicated that investors would have access to the preliminary prospectus and would be reminded that detailed financial information regarding the issuer can be found in the prospectus. *See, e.g.*, *Private Financial Network*, SEC No-Action Letter [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,332 (Mar. 12, 1997); *Net Roadshow, Inc.*, SEC No-Action Letter [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,367 (Sept. 7, 1997).

• **Corporate "Web Site" Communications.** Corporate sites on the world wide web are an important disclosure tool. Among other issues, the Commission has been required to refine its views regarding potential liability for such disclosure. For example, the SEC's staff has expressed its view that a mere reference to a corporate web site in a registration statement does not serve to incorporate all of the contents of the web site into the registration statement (and expose the contents to the heightened liability standards under the Securities Act). *See, e.g., ITT Corp.*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 895 (Dec. 6, 1996); *BG&E Corp.*, SEC No-Action Letter, 1997 No-Act. LEXIS 14 (Jan. 6, 1997).

• **Proxy Solicitations.** Corporations have taken advantage of the Internet to distribute proxy materials, and at least one company has broadcast its annual meetings over the Internet. John C. Wilcox, *Electronic Communication and Proxy Voting: The Governance Implications of Shareholders in Cyberspace*, Insights, March 1997, at 9, 10. Electronic proxy solicitation over the Internet has led to concerns regarding notice of delivery, access to information, and evidence of delivery. The SEC has indicated that delivery to an investor's e-mail account was equivalent to sending information through the normal mails, but that information placed on a web page would require a separate, more direct notice of availability of the information, such as through some type of prompting mechanism. *See October 1995 Release* at *16. Specifically, the SEC stated that an investor should be able to download or print electronic documents and that they should not be any more burdensome to read than paper ones. *See id.* at *13, *16-*17. In addition to the above SEC requirements, the issuer must be able to confirm that the investor has received, accessed, downloaded, or printed the electronic information through an electronic mail return receipt or a receipt of revocable informed consent from an investor to receive electronic information; otherwise, the company would have to still mail a paper copy to the investor. *See id.* at *19-*20.

• **Mutual Funds.** Investment companies, including mutual funds, have become the primary domain of the individual investor. Over 38 million U.S. investors have invested more that $4.6 trillion in 4,000 investment companies. *Report to Congress*, at 17. Mutual funds have used web sites to provide information about their funds to potential investors and have developed systems for selling shares directly to investors rather than through third parties. The use of such technology gives rise to unique issues under the separate regulatory structure established for mutual funds. One adviser, for example, sought confirmation that portfolio transaction information posted on their web pages would not violate the prohibition, in Rule 206(4)-1(a) under the Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-1(a), on the distribution of advertisements referring to specific recommendations by an investment adviser that could have been profitable to any person. In response, the SEC's staff agreed in a no-action letter that such information, in this context, would not constitute an "advertisement" subject to the rule. *See Munder Capital Management*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 518 (May 17, 1996).

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As with each of these issues, the SEC's position regarding NASDAQ order execution has evolved with the technology available for such transactions. At one point, the duty of best execution could be satisfied by securing three stock quotes over the telephone. *See* Order Execution Obligations, Exchange Act Release No. 36310, 60 Fed. Reg. 52,792, 52,793 (Sept. 29, 1995). Nearly two years after the class period, the Commission, following an extensive comment period, amended its rules, on a prospective basis, to require that prices offered by broker-dealers on "electronic communications networks" - examples of which include Instinet and SelectNet - be incorporated into their quotations on the NASDAQ system. *See* Order Execution Obligations, Exchange Act Release No. 37619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996). While the Commission has acknowledged that, during the class period, execution of

NASDAQ trades at NBBO "was 'generally' viewed as consistent with best execution for order handled on an automated basis,"[7] the Commission later refined that position because "the development of efficient new facilities has altered what broker-dealers must consider in seeking best execution of customer orders."[8] The Third Circuit did not explain how adherence to then-existing regulatory standards could reflect an intent to commit fraud in the context of a marketplace that necessarily must look to the SEC to establish standards for adapting frenetic technological changes.[9]

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[7] SEC Supplemental Brief, *Amicus Curiae* (Nov. 21, 1997) at 2. *See also* Division of Market Regulation, S.E.C., *Market 2000, An Examination of Current Equity Market Developments, at V-5*, 1994 SEC LEXIS 136, at *15 (Jan. 1994) (broker-dealer's use of the NBBO fulfills the duty of best execution).

A blue-ribbon committee, chaired by Former SEC Chairman David S. Ruder, concluded in 1991 that "when orders are executed at the best current displayed bid or offer that investors receive best execution of their small-sized orders regardless of the order-routing arrangements practiced by their brokers." David S. Ruder et al., *Inducements for Order-Flow, A Report to the NASD Board of Governors*, July 1991, at 26. The committee further concluded that, "the SEC, in approving the operations and regulatory requirements of SRO-sponsored and independent automated systems that execute orders at the best published price, appears to have recognized that, in automated executed systems, matching the best displayed bid or offer satisfies the standard for best execution for small-sized orders." *Id.*

[8] Order Execution Obligations, 61 Fed. Reg. at 48,322-23.

[9] For more than two decades, this Court has required that conduct actionable under Section 10(b), and Rule 10b-5, involve "scienter" or "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)

C. An Expert Agency is Uniquely Suited to Adapt the Regulatory Structure to Changes in Information Technology

The District Court below declined "to retroactively second-guess the SEC." *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. at 774. The Third Circuit's *en banc* decision accepted that invitation by suggesting that, because two services - Instinet and SelectNet - were available during the class period, "a trier of fact could infer that the defendants' acceptance of the orders was reasonably understood as a representation that they would not be executed at NBBO price when better prices were reasonably available elsewhere." *Newton*, 135 F.3d at 266. A marketplace executing in excess of 1.6 billion transactions annually cannot allocate its obligations on what a trier of fact subsequently "could infer."

This Court has long recognized that Congress established expert agencies to regulate highly complex and technical areas; thus, following Congress's will, this Court frequently defers to an agency's interpretation of its governing statutes and rules because the agency's knowledge and expertise is superior to that of the judiciary in the area of law the agency is charged with enforcing. *See, e.g., Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 845 (1986). This deference is a product both of an awareness of the practical expertise which an agency normally develops, and of a willingness to accord some measure of flexibility to such an agency as it encounters new and unforeseen problems over time." *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979).

In the securities arena, Congress repeatedly has recognized the critical nature of the SEC's guidance and the public's need to rely on such guidance. For example, Section 23(a)(1) of the Exchange Act, 15 U.S.C. § 78w(a)(1), provides that no liability shall attach "to any act done or omitted in good faith in conformity with a rule, regulation, or order of the

Commission." Similarly, Congress specifically recognized the need for the SEC's interpretation of technology issues in enacting the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416. Under this statute, the SEC was required to report on the impact of technological advances on the securities markets. The SEC's response acknowledged the agency plays an important role in guiding market participants in how to abide lawfully by the securities laws while at the same time taking advantage of technological innovations. *See Report to Congress*, at 1 ("The Commission is mindful of the benefits of increasing use of technology . . . and has encouraged experimentation and innovation by adopting flexible interpretations of federal securities laws.").

The most pernicious aspect of the Third Circuit's ruling is that it usurps the rulemaking function specifically entrusted to the Commission by Congress. As outlined above, the SEC continues to adapt its regulatory requirements to a marketplace that must accommodate continually changing technological capabilities. Marketplace participants must rely on that guidance for a measure of certainty in their activities. The Third Circuit's opinion, at the behest of private litigants, reassesses regulatory standards for the 1992-94 class period – without the procedural protections that accompany SEC rulemaking.

In granting summary judgment in this case, the District Court recognized that Congress had conferred regulatory power upon the SEC, not the judiciary, to oversee the nation's securities markets. "It is inappropriate for courts to interfere with that mandate except under extraordinary circumstances." *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. at 773. The Third Circuit's *en banc* decision would facilitate the second-guessing of a decision made by an expert agency – in this case and others. This Court, appropriately, has discouraged such reviews.

III. THE BREADTH OF THE THIRD CIRCUIT'S OPINION CONFLICTS WITH RULINGS OF THIS COURT THAT SECTION 10(b) CAPTURES ONLY FRAUD

The sweeping *en banc* decision is distinctive in the breadth of its interpretation of Section 10(b). The Third Circuit recognized the novelty of its decision, noting that "the practice of exclusive reliance on the NBBO *has never been held to be fraudulent by any court or regulator*." *Newton*, 135 F.3d at 774 (emphasis supplied). Left unexplained was just how reliance on a universal system for quoting prices could constitute a fraud under Section 10(b) when - as the SEC noted before the Third Circuit - no alternative system was mandated during the class period. *See* SEC Supplemental Brief, *Amicus Curiae* (Nov. 21, 1997) at 6-7; SEC Brief, *Amicus Curiae* (Oct. 17, 1996) at 10-12.

This reading of Section 10(b) is not only at odds with this Court's concern with certainty and predictability as discussed above, but also with this Court's rejection of expansive interpretations of Section 10(b). *See, e.g., United States v. O'Hagan*, 117 S. Ct. 2199, 2213 (1997) (noting that this Court has confined the Section 10(b) private right of action); *Ernst & Ernst*, 425 U.S. at 214 (rejecting expansive reading of 10(b) by holding that intent is a basic element of every broker misconduct claim); *Santa Fe Indus. v. Green*, 430 U.S. 462, 478-79 (1977) (a violation under the statute or rule can occur only if the conduct at issue involves manipulation or deception); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1974) (construing Section 10(b) and Rule 10b-5 to require plaintiff to be purchaser or seller of securities in question).

The Third Circuit's expansive decision here conflicts with a recent Fourth Circuit decision concerning, among other things, allegedly excessive markups and Section 10(b). *Banca Cremi*, 132 F.3d at 1034-35. In *Banca Cremi*, the Fourth Circuit affirmed the grant of summary judgment to the defendant securities broker, even though plaintiff's expert had testified that

his examination had shown that all of the markups at issue were excessive. *Id.* at 1034-35. Like the respondents here, plaintiff in *Banca Cremi* had argued that "securities dealers have an inferred duty to disclose certain markups, despite the SEC's specific decision not to require such disclosures through regulations." *Id.* In rejecting that argument, the *Banca Cremi* Court noted it was "acutely uncomfortable," with the proposition that, in the absence of any SEC regulation prohibiting such conduct, the issue of whether excessive markups had occurred could be put to a jury simply based on the opinion of a paid expert after the fact. *Id.*

Amici share that discomfort with respect to the Third Circuit's opinion below. In a business environment in which the available information technology is evolving at a frenetic pace, it will always be possible to contend that the latest innovation made additional steps "feasible." A burgeoning market cannot order its obligations around a jury's *post hoc* determination about just how far a legal standard had evolved based on the technology then available. Market participants must be able to rely on existing regulatory guidance in structuring their affairs. Left intact, the Third Circuit's opinion undermines this reliance and the certainty that is critical to our capital markets.

CONCLUSION

For all the foregoing reasons, this Court should grant the Petition for a Writ of Certiorari.

Dated: June 1, 1998
New York, New York

Respectfully submitted,

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Supreme Court, U.S.
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No. 97-1768

IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, and DEAN WITTER REYNOLDS INC.,
Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,
Respondents.

On Petition for a Writ Of Certiorari to the United States Court Of Appeals for the Third Circuit

REPLY BRIEF FOR PETITIONERS

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TABLE OF CONTENTS

Reply Brief for Petitioners 1

TABLE OF AUTHORITIES

Cases: **Page**

Banca Cremi v. *Alex. Brown & Sons*,
132 F.3d 1017 (4th Cir. 1997) 8

Blue Chip Stamps v. *Manor Drug Stores*,
421 U.S. 723 (1975) 3

Ernst & Ernst v. *Hochfelder*,
425 U.S. 185 (1976) . . . . . *passim*

Forkin v. *Rooney Pace, Inc.*,
804 F.2d 1047 (8th Cir. 1986) 7, 8

International Brotherhood of Teamsters v. *Daniel*,
439 U.S. 551 (1979) 5

McDonald v. *Alan Bush Brokerage Co.*,
863 F.2d 809 (11th Cir. 1989) 7

Messer v. *E.F. Hutton & Co.*,
847 F.2d 673 (11th Cir. 1988) 6

Musick, Peeler & Garrett v. *Employers Insurance*,
508 U.S. 286 (1993) 6

Platsis v. *E.F. Hutton & Co.*,
946 F.2d 38 (6th Cir. 1991) 7

Santa Fe Industries v. *Green*,
430 U.S. 462 (1977) . . . . . *passim*

Statute and Regulations:

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b) . . . . . *passim*

Division of Market Regulation, United States Securities and Exchange Commission, *Market 2000: An Examination of Current Equity Market Developments*, 1994 SEC Lexis 136 (Jan. 1994) 4

Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792 (Sept. 29, 1995) 5

Exchange Act Release No. 34-33377, 58 Fed. Reg. 69,419 (Dec. 23, 1993) 5

Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042 (Nov. 1, 1984) 5

Miscellaneous:

1 Alan R. Bromberg & Lewis D. Lowenfels, *Securities Fraud and Commodities Fraud* (2d ed. 1997) 3

Robert L. Stern, Eugene Gressman, Stephen M. Shapiro & Kenneth S. Geller, *Supreme Court Practice* (7th ed. 1993) 3

REPLY BRIEF FOR PETITIONERS

Respondents do not dispute our description of what the Third Circuit did. The court of appeals ruled that securities broker-dealers, simply by offering their services, "impliedly represent" that they will take all "reasonably available" steps "to maximize the economic benefit to the client in each transaction" and that if a firm intends to execute small retail orders at the NBBO, but a jury later finds that better prices were "reasonably available," the firm is guilty of *fraud*. Pet. App. 6a-7a, 12a, 15a-16a. Respondents admit that, under the Third Circuit's test, the outcome of this case will depend on whether the jury finds that "better prices * * * were reasonably available" (Opp. 2-8)—a standard that transforms Rule 10b-5 into a guarantor of reasonableness rather than a proscription against fraud.

Respondents do not contest our showing that a broker-dealer's only pertinent implied representation is that it will abide by trade custom and that execution at the NBBO was "almost universa[l]" industry practice, was approved in published guidance from the SEC and NASD, and was "no secret." Pet. App. 15a, 74a. Nor do they dispute our showing that imposition of a duty to "maximize" the economic benefit to customers in principal trades would deprive broker-dealers of the compensation for market-making services expressly allowed by the regulatory scheme applicable to dealers. They make no serious effort to explain how the Third Circuit could hold that a known and nearly universal practice, approved by regulators, could possibly be "fraud," or how that court's application of Rule 10b-5 to patently nonfraudulent conduct can be reconciled with *Hochfelder*, *Santa Fe*, and numerous cases in other circuits.

Respondents also do not answer our showing that this case is of major importance because of its extraordinary magnitude and the burden it imposes on the judiciary. Nor do they deny that the Third Circuit's new approach to Rule 10b-5—impute a representation that the firm will "do its best" and impose *fraud* liability if a jury later decides the firm could have done better—would lead to a proliferation of litigation and vast new liabilities in scores of pending and future cases.

Instead, respondents urge this Court to deny certiorari because this case is supposedly fact-bound, because it arises at the summary judgment stage, and because SEC litigators expressed partial support below for some of their views. None of these contentions survives scrutiny.

1. Petitioners vigorously dispute respondents' factual allegations in this case, including whether, in real life and real time, a firm would better serve customers who place small retail market orders by pausing to search for better-than-NBBO prices. See Opp. 12, 15-17. But these disputed facts make no difference to the outcome of this case because the legal issues are dispositive. There can be no Rule 10b-5 liability on *any* version of the facts respondents say are in dispute.

First, the issue under *Hochfelder* and *Santa Fe* is whether petitioners intended to deceive, not whether a jury later concludes that they acted "reasonably." This is a fraud case, not a negligence case. See Pet. 15-21. Second, it is immaterial that a few brokers may have believed they should go beyond NBBO, because there is *no* dispute "that execution of customer orders at the NBBO was a practice 'widely, if not almost universally followed' in the securities industry during the class period." Pet. App. 15a. Whatever its relevance to claims of breach of fiduciary duty, a difference of opinion among brokers about what is "reasonable" does not make the overwhelming majority viewpoint "fraud." Finally, whether petitioners "intended" to violate a judicially "implied representation" to customers is a question of fiction, not fact. The Third Circuit was not free to invent a representation inconsistent with industry practice and regulatory guidance. The question whether a broker "intended" to act contrary to such a fictitious representation is legally immaterial. See Pet. 22-23.

This is not, in short, a case where any disputed fact makes any difference to the outcome. The legal issues are dispositive and require entry of judgment for petitioners, as the district court and panel recognized.

2. Because the legal issues raised in our petition will not be affected by further factual development, the interlocutory posture

of the case is no barrier to immediate review. See Stern, et al., *Supreme Court Practice* 196 (7th ed. 1993) (a case presenting an "important and clear-cut issue of law that is fundamental to the further conduct of the case and that would otherwise qualify as a basis for certiorari * * * may be reviewed despite its interlocutory status"). Interlocutory review is particularly appropriate in securities fraud cases, especially cases of this extraordinary magnitude that are amenable to termination on summary judgment.

Respondents concede that this Court often grants certiorari to review interlocutory Rule 10b-5 decisions when there is disagreement among the circuits, as there is here. Opp. 16-17 & n.10. But respondents fail to recognize that, as a practical matter, interlocutory review is likely to be this Court's *only* opportunity to clarify important legal principles arising under Rule 10b-5. Because even a Rule 10b-5 "complaint which [is weak] by objective standards * * * has a settlement value * * * out of any proportion to its prospect of success at trial," provided the plaintiffs can survive "dismissal [and] summary judgment" (*Blue Chip Stamps*, 421 U.S. at 740), securities fraud class actions rarely go to trial. In consequence, in order to "fashio[n] substantive law * * * in a manner which makes it easier * * * for a defendant to obtain a summary judgment" disposing of "groundless" Rule 10b-5 suits, this Court has repeatedly granted certiorari to review securities fraud rulings in this same procedural posture. *Id.* at 740, 742-743; Pet. 26-27. See 1 *Bromberg and Lowenfels on Securities Fraud,* p. 2:108, referring to "an avalanche of more than 20 Supreme Court decisions," most rendered at the interlocutory stage: "[t]here can be little doubt about the intensity of the Court's concern over the expansion of securities liability, and its determination to curb."

The burden on the parties and the district court if this litigation were allowed to proceed would be immense. Respondents seek discovery of trillions of dollars in securities transactions in the world's busiest securities market and will be "trying [this] case if it goes back [down] for years." Tr. of Oral Argument at 9 (Oct. 24, 1996). Given its defective legal basis, this massive case should not be permitted to lumber forward.

More important, the Third Circuit's new definition of securities fraud, if left unreviewed, would have serious consequences throughout the securities business, as the three amicus briefs urging this Court to grant certiorari attest. Respondents do not deny that, because executing orders at the NBBO was nearly universal industry practice, the Third Circuit's decision invites suits against virtually every broker-dealer. Nor do respondents identify any limits to the Third Circuit's fraud theory to counter our showing (Pet. 24-25) that it turns every claim that a broker-dealer violated a duty of fair dealing or best execution into a Rule 10b-5 suit and "could not be easily contained." *Santa Fe*, 430 U.S. at 478. By cobbling together a fraud theory out of fictional "representations" and constructive "intent" and making fraud turn on questions of "reasonableness" and "feasibility," the Third Circuit has encouraged a proliferation of new Rule 10b-5 class action suits challenging conduct that, as the court acknowledged, "has never [before] been held to be fraudulent by any court or regulator." Pet. App. 15a.

3. Respondents rely heavily on the SEC's amicus briefs in the Third Circuit. Opp. 9-11, 14-15, 19 n.11. But respondents misdescribe those briefs. The SEC's lawyers told the court of appeals only that they could not "state categorically" that execution at the NBBO "always" satisfies best execution and that the duty of best execution might under some circumstances "be capable of enforcement under the antifraud provisions." See *id.* at 10, 11. But of far greater relevance here, the SEC's counsel confirmed that "the Commission never required that broker-dealers engage in an order-by-order analysis of competing markets during the class period in order to satisfy the duty of best execution" and agreed with petitioners that there were no "alternative systems offering better prices that were reasonably available * * * during the class period." Supp. Br. of the SEC as Amicus Curiae at 6. This alone precludes liability for fraud.

During the class period the SEC published a major report concluding that execution of NASDAQ market orders at the NBBO is "consistent with best execution, absent customer instructions to the contrary." *Market 2000*, 1994 SEC Lexis 136, at *15. The

agency also had previously approved the NASD's mandatory Small Order Execution System, which automatically executed orders at NBBO. See Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042, 44,044 (Nov. 1, 1984); *id.*, No. 34-33377, 58 Fed. Reg. 69,419, 69,420 (Dec. 23, 1993). Shortly after the class period, the SEC reaffirmed that "[i]n the past," executions at the NBBO "were generally recognized as satisfying best execution obligations." Exchange Act Release No. 34-36310, 60 Fed. Reg. 52,792, 52,794 (Sept. 29, 1995). These contemporaneous agency pronouncements foreclose any rational inference of scienter or deception. See *Daniel*, 439 U.S. at 566 (the SEC's "past actions," not statements in amicus briefs, are entitled to weight).

4. The Third Circuit relied on the "shingle theory" to impute to a broker-dealer the representation that it would seek every "reasonably available" source of liquidity to "maximize [its customers'] economic benefit." Pet. App. 10a; see Pet. 22. We demonstrated in our petition that dealers have no such duty and that the shingle theory does not imply any such representation. Without exception, court decisions, SEC rulings, and expert commentaries state that a firm, by offering its services, represents only that *it will act in accordance with industry standards and practices*. The shingle theory has never been used to impute a representation that a broker-dealer would act *contrary* to an "almost universa[l]" industry practice. See Pet. 22-23.

Judicial imposition of a duty inconsistent with regulatory guidance and industry practice would deprive the industry of the certainty required to execute millions of transactions swiftly and accurately in volatile securities markets through sophisticated computer and network technology. Respondents only confirm this when they try to distance themselves from the Third Circuit's description of the duty as requiring "reasonable efforts," as determined by a jury, "to maximize the economic benefit to the client in each transaction." Opp. 19 n.11; see Pet. App. 7a, 11a-12a, 13a. Respondents prefer to say that a firm has a duty to obtain the best reasonably available price, but in the real world, as the SEC has always recognized, "best execution" for the customer also depends on "order size, trading characteristics of the security,

speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." Supp. Br. of SEC as Amicus Curiae at 5; Pet. App. 9a. If industry practice and regulatory guidance are discarded as guides, it is impossible, as the district court found, to know "what best execution means." Pet. App. 72a.

In an effort to establish a new duty to seek better-than-NBBO prices, respondents relied principally below and in their opposition (at 5-6) on the declaration of former SEC Commissioner Richard Roberts, who opined that a broker may violate its duty of best execution if it executes an order at the NBBO when a "superior price" is "available on Instinet or SelectNet." Addendum A1-A3, ¶ 7. The en banc court expressly relied on that opinion as demonstrating what "respected members of the brokerage community recognized" during the class period. Pet. App. 13a. But Roberts recently informed respondents that he has "reconsider[ed] the opinions" in his declaration, "particularly" the one just quoted, and told respondents they are "not authorized" to use this declaration "in any manner" in "this or any other litigation." Addendum A1-A2. It would be extremely unfair to impute to broker-dealers, long after the fact, a duty during the class period that respondents' own declarant now declines to support. By imposing such a duty on an ad hoc and retroactive basis, the Third Circuit has created tremendous uncertainty in an area where "clarity" and "consistency" are essential. *Musick, Peeler*, 508 U.S. at 295.

5. Under *Hochfelder*, a broker-dealer following virtually universal industry practice that comports with regulatory guidance and is "no secret" to investors cannot as a matter of law be acting with scienter. Pet. 15-16. Respondents' only answer to our showing (Pet. 16-18) that the Fourth, Fifth, Sixth and Eleventh Circuits have all so held is to contend that additional factors in those cases—beyond evidence that the allegedly fraudulent conduct was "a common and accepted industry practice"—suggested a lack of intent or recklessness. *Messer*, 847 F.2d at 678; see Opp. 18-21. But the fact that the defendant followed trade custom was the dominant factor in each decision; there can be no serious question that each of those courts would hold that petitioners here lacked

scienter. See, *e.g.*, *Platsis*, 946 F.2d at 41 ("intent to deceive * * * could not be established" where allegedly fraudulent omission was common industry practice and "there was no established regulatory duty to disclose"). It is telling that respondents, while trying to downplay the conflicts we have identified, cannot cite a single decision that supports the Third Circuit's radical approach to scienter.

The notion that a broker-dealer had the requisite "mental state embracing intent to deceive, manipulate, or defraud" is particularly absurd when a representation is retroactively implied based on a jury's view of what was "reasonable"—so that the broker-dealer's "intent" with regard to that representation is purely constructive. *Hochfelder*, 425 U.S. at 193 n.12; see Opp. 12-13. As the Eleventh Circuit held in *McDonald*, 863 F.2d at 815—a case cited in our petition that respondents fail to mention—a "reasonableness" inquiry "may establish negligence" but it "does not meet the standard for scienter." Former SEC Commissioner Roberts' change of heart about whether broker-dealers should have sought better prices for small orders on Instinet or SelectNet vividly illustrates the dangers of imputing scienter based on jury conjecture about what was reasonable or unreasonable. See *Hochfelder*, 425 U.S. at 190 n.5 (even "inexcusable negligence" does not constitute scienter).

6. Even if there were some merit to respondents' suggestion that better prices were available, an "unreasonable" failure to obtain those prices would at most raise an issue of fiduciary duty. As respondents concede (Opp. 21), under *Santa Fe*, a breach of fiduciary duty, where there is no misrepresentation or lack of necessary disclosure, is not actionable under Rule 10b-5.

Following *Santa Fe*, other circuits have expressly required manipulation or deception. Respondents attempt to explain away the conflicts we identified by claiming that the cited cases did not involve allegations of nondisclosure or misrepresentation. Opp. 21 n.13; see Pet. 20-21. But *Forkin* is closely analogous to this case because it involved allegations that a broker violated an implied "representation of fair dealing." 804 F.2d at 1050. Those allega-

tions raised only issues of breach of fiduciary duty, not fraud; the Eighth Circuit accordingly held Rule 10b-5 inapplicable. A contrary result, the court recognized, would mean that "every instance of broker misconduct would give rise to a cause of action under the anti-fraud provisions of the federal securities laws." *Ibid.* In *Banca Cremi*, the Fourth Circuit likewise refused to countenance a fraud action based on violation of an alleged implied duty to disclose trading practices. 132 F.3d at 1035. The Third Circuit has permitted what these and other circuits forbid: use of an entirely fictitious representation to convert allegations of breach of fiduciary duty into an action for securities fraud.

This Court should grant review to restore the bounds of securities fraud liability established in *Hochfelder* and *Santa Fe* and to prevent the massive burden and industry-wide disruption that will be inflicted by the Third Circuit's faulty legal ruling.

Respectfully submitted.

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June 1998

Counsel for Petitioners

ADDENDUM

LETTER FROM RICHARD Y. ROBERTS TO RESPONDENTS' COUNSEL DATED MAY 27, 1998

Richard Y. Roberts
3916 Bentwood Court
Fairfax, Virginia 22301

May 27, 1998

Ms. Karen Morris
Morris and Morris
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Wilmington, Delaware 19801

IN RE MERRILL LYNCH, et al.
SECURITIES LITIGATION
CIVIL ACTION No. 94-534

Dear Ms. Morris:

On January 30, 1998, the United States Third Circuit Court of Appeals reversed a decision of the United States Court for the District of New Jersey granting summary judgment for the defendants in the above-referenced litigation. In the original District Court case, I submitted a Declaration in opposition to the motion for summary judgment by defendants which Declaration was dated October 25, 1995. I hereby notify you in writing that I am not inclined to participate in this litigation in any manner in the future. Further, I hereby notify you in writing that you are not authorized to use in any manner my Declaration dated October 25, 1995, in this or any other litigation. Moreover, I request that you inform the United States Court for the District of New Jersey, as well as opposing counsel in this litigation, of this notification.

A great deal has occurred in the rulemaking and enforcement area by the United States Securities and Exchange Commission, among others, between October 25, 1995, and January 30, 1998, which relates to the subject matter made the focus of the above-referenced litigation. These subsequent events have caused me to reconsider the opinions contained in my Declaration dated October 25, 1995, particularly the one contained in paragraph 7 of that Declaration. Thus, I am not necessarily prepared at the present to express the same opinions set forth in my Declaration dated October 25, 1995.

Sincerely,

/s/ Richard Y. Roberts

EXCERPT FROM DECLARATION OF RICHARD Y. ROBERTS DATED OCTOBER 25, 1995

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

IN RE MERRILL LYNCH, et al. SECURITIES LITIGATION	)))	CIVIL ACTION NO. 94-5343 (DRD)

DECLARATION OF RICHARD Y. ROBERTS

STATE OF NEW JERSEY	)	
	)	ss.:
COUNTY OF MERCER	)	

I, RICHARD Y. ROBERTS, declare under penalty of perjury that the following is true and correct: * * *

7. It would be inconsistent with the duty of best execution for a broker-dealer to advantage itself by automatically executing customer market orders at the NBBO when superior prices are reasonably available. In my opinion, during the Class Period, absent customer instructions to the contrary, a broker-dealer failed to fulfill its duty of best execution to a customer if the broker-dealer did not execute the customer's order at a reasonably available superior price, including such a price available on Instinet or SelectNet (which systems constitute a substantial portion of Nasdaq trading volume), and instead executed the order at the NBBO.